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STUDENT AID

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*We Help Put America Through School*

**FISCAL YEAR 2003  
PERFORMANCE AND  
ACCOUNTABILITY REPORT**



## FEDERAL STUDENT AID

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## **PART I**

# **MANAGEMENT'S DISCUSSION AND ANALYSIS SECTION**



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**A MESSAGE FROM THE CHIEF  
OPERATING OFFICER**



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CHIEF OPERATING OFFICER

November 12, 2003

Dear Customers and Stakeholders,

I am pleased to present the Fiscal Year (FY) 2003 Annual Performance and Accountability Report for the Office of Federal Student Aid (FSA), Department of Education. I am also extremely pleased to report that FSA has earned its second consecutive unqualified opinion on its audited financial statements, achieving one of FSA's top priorities. Additionally, this year, FSA met the Office of Management and Budget's (OMB) mandated accelerated time frame for FY 2004 year-end reporting, a year earlier than required. This clearly demonstrates that FSA has established a firm foundation for financial management excellence as a result of the Secretary's focus on the President's Management Agenda initiatives and the issues that have historically caused the federal student aid programs to remain on the General Accounting Office (GAO) High-Risk List. Unqualified audit opinions in FY 2002 and again in FY 2003, coupled with the elimination of the longstanding financial management material weakness in FY 2003, is clear-cut evidence of sustained exceptional financial management performance by FSA.

I must thank the many people within FSA and across the Department for their hard work, dedication, and collaboration to improve our systems, programs, processes, and procedures so that we could attain this significant goal.

This is my second year as Chief Operating Officer (COO) and the second year that FSA has received an unqualified ("clean") opinion. In FY 2003, I worked closely with the FSA senior management team and staff, and others across the Department, to ensure that we continued to build on efforts begun in FY 2002 to maintain an unqualified opinion. FSA's structured planning and performance reporting process for this year aligned FSA's priorities with the strategic drivers of our work and enabled us to identify opportunities to improve and more clearly demonstrate the manner in which FSA meets its primary statutory responsibilities to:

- Improve service to students and other participants in the student financial assistance programs.
- Reduce the costs of administering the programs.
- Improve and integrate the information and delivery systems that support the programs.
- Ensure program integrity.





We have prioritized our FY 2004 project efforts with the important mandates of the Performance-Based Organization (PBO) as guiding principles. Our goals of maintaining an unqualified financial statement audit opinion and of permanent removal of the federal student aid programs from the General Accounting Office High-Risk List are first, closely followed by our continued efforts to integrate our remaining legacy systems and migrate them to newer technology solutions, as appropriate.

Critical projects to improve customer service, integration, and program integrity for FY 2004 include:

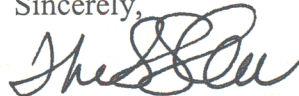
- Continuing to strengthen and align our processes and procedures to support our new financial management system.
- Improving program compliance, monitoring, and integrity by continued implementation of an enterprise data vision, strategy, plan, and framework, to ensure data consistency, quality, and integrity across our systems and for providing our customers with easy access to the data they need.
- Ensuring that FSA's workforce is adequately prepared to meet future challenges and accomplish our important mission.

The accomplishments identified in this report, and our focused plans for the future, clearly demonstrate our commitment to deliver the right aid, to the right people, at the right time. FSA is dedicated to providing seamless and superior service in our daily operations, and to our quest to provide better system solutions and better business processes that have significant impact on ensuring program integrity, providing better customer service, and reducing the cost of program administration. I am continuing to hold myself, and every FSA staff member, to the highest performance and accountability standards in carrying out our mission.

As required by the Reports Consolidation Act of 2000, I assert that the financial and performance information contained in this report is complete and reliable. Based on our own internal evaluations and that of the independent auditor's report, FSA does not have any material deficiencies to report for FY 2003. FSA is in compliance with all requirements of the Federal Managers' Financial Integrity Act (FMFIA) of 1982, and FSA's financial management systems are in compliance with the Federal Financial Management Improvement Act (FFMIA) of 1996.

I look forward to working with all of you in the coming years as we continue to provide outstanding customer service, to integrate our systems, and to ensure the appropriate management and oversight of the federal student aid programs.

Sincerely,



Theresa S. Shaw



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Management's Discussion and Analysis (MD&A) provides an overview of the Office of Federal Student Aid (FSA) and the student financial assistance programs. It describes who we are, what we do, and how well we meet the goals we have set. It also addresses our financial performance and our management control responsibilities. To comply with the Reports Consolidation Act of 2000 (P.L.106-531), FSA's Accountability Report and Annual Performance Report are combined for the first time in this one consolidated Performance and Accountability Report (PAR). Following an overview of our organizational structure and mission is a discussion of our programs, performance objectives and goals, and financial management for FY 2003, which ended September 30, 2003. The audited financial statements can be found on page 52. A discussion of our performance goals and results begins on page 23.

### MISSION AND ORGANIZATIONAL STRUCTURE

#### **FSA Transformation**

The Higher Education Amendments of 1998 established a performance-based organization (PBO) to modernize the delivery of the Department of Education's student financial assistance programs. Efforts were made to transform the Office of Student Financial Assistance into a PBO. Strategies were developed for meeting the performance goals set forth in the authorizing legislation. The organization began its transformation into a customer-focused, results-driven organization. Since the early days of the PBO, FSA has continued to meet short and long-term objectives and goals established annually in both the Department's and its own Five-Year Strategic Plans. Both are aligned to goals contained in the President's Management Agenda. FSA and the Department promote a culture of accountability that has been a key component of the Secretary's "Blueprint for Management Excellence."



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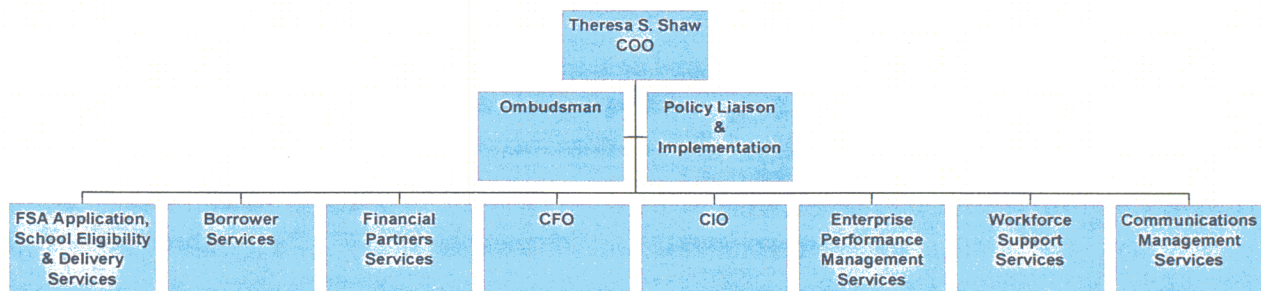
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### Mission

**We Help Put America  
Through School**

FSA's mission is to "help put America through school" by providing access to higher education through effective and efficient delivery of student aid. FSA was created with a mandate to improve customer service, reduce cost, and improve and integrate the student aid processing and delivery systems.<sup>1</sup>

### FSA Organizational Structure



The Chief Operating Officer (COO), appointed by the Secretary of Education for up to a five-year term, heads FSA. In September 2002, Theresa S. Shaw became FSA's second COO. She proposed, and the Department approved, a new organization structure for FSA that is aligned with FSA's strategic drivers, business objectives, and operational goals. Implemented on July 13, 2003, the new structure provides a more effective and efficient operation in delivering student financial assistance; it also provides better management of the inherent risks of the programs. FSA is guided by five strategic objectives, which are closely linked to the PBO goals identified in the authorizing legislation:

<sup>1</sup> FSA, formerly the Office of Student Financial Assistance and the Office of Student Financial Assistance Programs within the Office of Postsecondary Education (OPE), was authorized by the Higher Education Amendments of 1998 and became the federal government's first-ever PBO. FSA, which changed its name on March 6, 2002, is a principal operating component within the Department of Education, separate from OPE.





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- Integrate FSA systems and provide new technology solutions.
- Improve program integrity.
- Reduce program administration costs.
- Improve human capital management.
- Improve products and services to provide better customer service.

### **FSA Operating Functions**

The FSA organization functions as a result of leadership provided by the COO and six General Managers (GMs), a Chief Information Officer (CIO), and a Chief Financial Officer (CFO). Senior leadership demonstrates management excellence every day and provides the following services to our customers and the organization.

The GM for Application, School Eligibility, and Delivery Services is charged with improving student and borrower awareness of financial aid options; ensuring the smooth and efficient processing of student transactions; providing assistance to schools to ensure they can meet program eligibility requirements; reviewing schools for compliance with program requirements; and overseeing ongoing financial and other transactions with schools.

The GM for Borrower Services manages all functions and activities that will ensure better services to borrowers who are repaying federal education loans and debts and will help students and parents understand their repayment obligations. The business areas and systems under Borrower Services include: Loan Repayment and the Direct Loan Servicing System (DLSS), and Direct Loan eServicing; Collections and the Debt Management Collection System (DMCS); Consolidation and the Loan Consolidation System; Conditional Disability, Discharge Tracking System (CDDTS); Portfolio Risk Management; and the Credit Management Data Mart.

The GM for Financial Partners Services promotes the best in business service to lenders and guaranty agencies and strives for greater program integrity through innovative technical development, oversight, technical assistance, and community outreach programs. The GM works in partnership with guaranty agencies, lenders, servicers, trade association, trustees, schools, and secondary markets to ensure access for students to federal student loans.





The CIO provides technical support to:

- GMs in the development and maintenance of new system applications.
- The CFO in implementing an integrated financial management system that will support FSA's financial performance.
- Other operating units in designing efficient and effective systems to support operations.

The CIO also oversees the FSA Virtual Data Center, where most of FSA's production systems are located and supported for reliability, performance, and availability to the business functions.

The CFO provides oversight of FSA's financial and internal control management, the Department's general ledger with all of FSA's financial data, internal audit management, travel management, budget and financial information analyses, and financial reports to all areas of FSA, the Department of Education, and external reporting entities. Additionally, the CFO oversees reconciliation of nearly a dozen financial-related systems to ensure timely and reliable data for internal and external decision-making. The CFO is also responsible for coordination of the annual audit of FSA's financial statements and for ensuring that appropriate financial reports are issued to the Department of Education, the Department of the Treasury, the Office of Management and Budget (OMB), and Congress.

The GM for Enterprise Performance Management Services provides project management oversight for all systems integration, re-engineering, and re-platforming projects; contract performance measures and measurement, performance plan monitoring; FSA performance against high risk; and internal audit resolution.

Other FSA business process managers that provide program support include:

- Workforce Support Services.
- Communications Management Services.
- Ombudsman.
- Policy Liaison and Implementation.

## **Achievement of Performance Goals**

The six GMs, the CIO, and the CFO report to the COO and ensure that their operating plans support Goal 6, *Establish Management Excellence*, of the Department's Strategic Plan. Annually, the COO and the management team identify FSA performance goals.



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Eighteen priority performance goals were established to guide our efforts for FY 2003. Progress was tracked throughout the year on the 18 projects that guided improvements in core business processes and operations and supported FSA's and the Department's Strategic Plans.

While FSA accomplished most of its FY 2003 goals, most notable are the following projects that support the PBO statutory goals and Goal 6.4, *Modernize the Student Financial Assistance Programs and Reduce Their High-Risk Status*, of the Department's Strategic Plan:

- FSA redefined and then re-baselined its customer service measures through an FY 2003 American Customer Satisfaction Index (ACSI) survey. Particularly noteworthy was the ACSI score of 86 for the *FAFSA on the Web* (FSA's internet student aid application product), which compares favorably with the score of 88 for Amazon.com, the highest rated company in the ACSI index.
- FSA continued to demonstrate success in its default management and prevention strategies.
  - During FY 2003 default collections totaled nearly \$1.33 billion, resulting in a recovery rate of 9.5%, far above the FY 2003 goal of 7.6%.
  - The annual Cohort Default Rate reached an all-time program low of 5.4% for the FY 2001 rate, which was released in September 2003.
- FSA met 100% of the targets in its sequencing plan and re-evaluated targets for FY 2004-2007.
- FSA completed 15 of the 18 FY 2003 priority projects and is on track to complete the three remaining projects.

One of the significant priority activities that is continuing into FY 2004 is the defining of a comprehensive Enterprise Data Strategy and Sequencing Plan to address system integration needs. The strategy focuses on FSA's overall approach to data and will ensure that accurate and consistent data is exchanged among FSA's systems, customers, partners, and compliance and oversight organizations. It includes plans for significant improvements in data quality and data consistency and supports FSA's program-wide goals of sustaining an unqualified ("clean") opinion on its financial statements and of removing the FSA programs from the General Accounting Office (GAO) High-Risk List. Many important deliverables have already been developed under this activity including "As-Is" System Data Flows, a Data Quality Report, Technical Strategies, and Access Management Business Objectives and High-Level Requirements. The final Enterprise Data Strategy and Sequencing Plan and Milestones document will be completed in November 2003.





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The work of the Department and FSA to improve financial management systems and their supporting systems and processes resulted in each receiving an unqualified opinion for FY 2002 on our financial statements. Both the Department and FSA received a second consecutive unqualified opinion for FY 2003. This accomplishment is critical to FSA's efforts to be removed from the GAO High-Risk List. More important, it reassures taxpayers that the Department and FSA are wisely managing resources in the delivery of federal student aid.

A few of our goals were not met, and we are establishing our FY 2004 Annual Plan with an understanding of the need to demonstrate progress in these important areas:

- The FSA programs were not removed from GAO's list of high-risk programs in its latest January 2003 designation, largely because of financial management issues (we had not received the unqualified opinion on our FY 2002 financial statements at the time of the designation). Although GAO commended the Department for its commitment and progress in addressing the issues identified in prior designations, we were disappointed with that outcome. This is still a top priority for FSA and the Department, and in FY 2004 we will continue to focus on the issues raised (improving financial management and internal controls, improving plans and reports to better demonstrate systems integration and default management progress, and improving human capital management) to ensure that a favorable designation is received in the next report, scheduled to be released in January 2005.
- Because of the importance of other priorities, in FY 2003 FSA did not sufficiently track its costs, using its activity-based costing model or other methodology, in order to determine whether we were progressing toward our statutory goal of reducing administrative costs. We fully understand the importance of this mandate, as reducing administrative costs was a fundamental strategy driving the activities we identified for our FY 2003 Annual Plan. In FY 2004 we are prioritizing efforts to build on our prior activity-based costing work and validate and re-baseline key business process costs with FY 2002 financial information. We also plan to finalize FY 2003 business process costs and have a sustainable measurement and reporting process in place for the future. We believe that our FY 2004 efforts will provide our stakeholders and Congress with more meaningful information on which to gauge our success in addressing this important goal.
- Although FSA met its target to reduce Pell Grant overpayments from 3.3% in FY 2002 to 3.1% in FY 2003, our overall erroneous payments rate, which includes underpayments, was 4.9%, higher than our target of 3.6%. Reducing erroneous payments is an important government initiative and a priority at the Department. The root cause of the overpayments and underpayments in the Federal Pell Grant Program has been identified as errors in applicant self-reported income information



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used to determine student eligibility. In FY 2004, we will continue to work with OMB and Treasury in support of proposed legislation to revise the Internal Revenue Service (IRS) Code to authorize the matching of the FSA applicant data to tax return data. Once legislation is passed, we will aggressively work with the IRS toward an effective business process to support the match.

The performance goals and outcomes are discussed in more detail in the Performance Section of this report.

### **The Programs We Administer**

Programs managed and administered by FSA include:

- William D. Ford Federal Direct Loan Program (Direct Loan).
- Federal Family Education Loan Program (FFEL).
- Federal Pell Grant Program.
- Campus-Based Programs (Federal Perkins Loan, Federal Work-Study, and Federal Supplemental Educational Opportunity Grant programs).
- Leveraging Educational Assistance Partnership and Special Leveraging Educational Assistance Partnership programs (LEAP/SLEAP).

In 2003, FSA delivered or facilitated the delivery of approximately \$92 billion in Federal aid to more than 9 million students and their families and supported consolidation loan borrowers. Under the FFEL and Direct Loan programs, FSA oversees or directly manages over \$311.2 billion in outstanding loans, representing over 73 million individual student loans. FSA interacts with over 6,500 schools, over 3,700 lenders, 36 guaranty agencies, dozens of accrediting agencies, as well as secondary markets, third-party servicers, state agencies, and other organizations.

In accordance with the PBO model, FSA has outlined:

- Clear objectives.
- Specific measurable goals.
- Customer service standards.
- Targets for improved performance.





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The following paragraphs briefly describe each of the major programs that deliver federal aid to students and their families.

The **Federal Pell Grant Program** helps ensure financial access to postsecondary education by providing grant aid to low- and middle-income undergraduate students. The most need-focused of the Department's student aid programs, Pell Grant awards vary in proportion to the financial circumstances of students and their families. For the 2002-2003 award year, the Department disbursed \$11.6 billion in Pell Grants, averaging \$2,402, to 4.8 million students. The maximum Pell Grant award amount increased from \$3,750 for the 2001-2002 award year to \$4,000 for 2002-2003.

Two major student loan programs account for most of the remainder of the Department's support for postsecondary education. The **Direct Loan Program** lends funds through participating schools directly to college students. The Department borrows funds from the U.S. Treasury to fund Direct Loans to students. Details on borrowings and interest on those borrowings are contained in the disclosures in Notes 5 and 11 of the Financial Statements. In FY 2003, the Department awarded \$16.5 billion in net loans (includes \$6.7 billion in consolidation loans) to 1.68 million Direct Loan recipients. The average subsidized Direct Stafford Loan was \$3,623, while the average unsubsidized loan was \$4,059.

Funds for the **FFEL Program** are provided by private lenders and are insured by guaranty agencies and reinsured by the federal government. During FY 2003, the Department facilitated the delivery of \$62 billion in net loans (including \$31.2 billion in consolidation loans) to 5.1 million FFEL recipients. The average subsidized FFEL Stafford loan was \$3,364, while the average unsubsidized loan was \$4,096. In addition, FSA paid over \$2.22 billion to lenders for interest and special allowance subsidies and over \$3.18 billion to guaranty agencies to reimburse them for defaulted FFEL loans, loan processing and issuance fees, and account maintenance fees required by the Higher Education Act of 1965, as amended (HEA).

The FFEL and Direct Loan programs offer borrowers a variety of repayment plans including standard, graduated, extended, and income contingent. The extended repayment plan became available to new FFEL borrowers after October 7, 1998, who have outstanding FFEL loans totaling more than \$30,000.

The Department's **Campus-Based Programs** provide funds to institutions that enable them to provide employment, grants, and low-interest loans on the basis of student needs. For the 2002-2003 award year, the Department disbursed approximately \$1.86 billion to approximately 3.5 million recipients.



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The **LEAP Program**, authorized by Section 415A of the HEA, makes federal funds available to assist states in providing student assistance programs for students with “substantial financial need.” The **SLEAP Program** is an addition to the LEAP Program, resulting from the 1998 Amendments to the HEA (Section 415E). SLEAP makes federal funds available to states to cover a third of the cost of supplementing their LEAP Program, supplementing their LEAP Community Service Work-Study programs, and/or providing Merit and Academic Achievement or Critical Careers Scholarships to students with substantial financial need.

### FINANCIAL DISCUSSION AND ANALYSIS

#### Overview

The preparation and audit of financial statements are significant functions, demonstrating the strength of the financial information, financial systems, and internal controls maintained by FSA. As steward of federal postsecondary education funds, FSA is committed to providing sound management, financial systems, and controls to ensure that students receive education funds according to applicable laws and regulations. FSA prepares annual financial statements in conformance with generally accepted accounting principles (GAAP). Our financial statements are subject to an annual independent audit to ensure that they are reliable and present fairly our financial position.

Last year, FSA received an unqualified opinion. However, the auditors did report a material weakness. The auditors found that “Financial management, reconciliations, and account analysis need to be strengthened.” In FY 2002, FSA developed a plan to improve the timeliness and quality of both the reconciliations and analyses performed. Considerable time and resources were devoted to correcting the deficiency. Those efforts were intensified in FY 2003, resulting in FSA consistently reconciling its accounts to the Department’s general ledger within 30 days after month-end close throughout the fiscal year. FSA also performed more rigorous analyses of account balances as called for in its plan. FSA received an unqualified opinion on its financial statements by the auditors for FY 2003. We attribute this unqualified opinion to significant improvements in our accounting and financial processes, successfully planning and meeting accelerated interim and year-end financial reporting requirements, and giving high priority to accomplishing this outcome.





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The auditors did not report any material weaknesses in FY 2003. They did, however, report two reportable conditions, credit reform and Information Technology (IT) security. Although much progress has been made in addressing findings in these areas, FSA continues to work with the Department to implement additional improvements.

### Financial Position

OMB 01-09, Form and Content of Agency Financial Statements, defines the form and content for federal agency financial statements. For FY 2002 and FY 2003, FSA prepared the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Statement of Financing on a consolidated basis. In FY 2002, the Balance Sheet, Statement of Net Cost and Statement of Budgetary Resources were prepared on a combined basis. An independent auditor, appointed by the Office of the Inspector General, audited these statements. The Report of Independent Auditors (opinion) on these statements and accompanying Reports on Internal Control and Compliance with Laws and Regulations are included in this report.

FSA has substantial assets currently under its management. Of the \$121.7 billion in assets held by FSA as of September 30, 2003, \$97.6 billion consists primarily of Net Credit Program Receivables held by the Direct Loan and FFEL programs, and \$22.7 billion consists of Fund Balance with Treasury. The Direct Loan Program holds \$86.6 billion, or 89% of Net Credit Program Receivables, while the FFEL and Perkins Loan programs hold \$11 billion, or 11%. (The FFEL portfolio consists of defaulted FFELs that the Department owns and collects.) The Net Credit Program Receivables are valued using a present value methodology, and the allowance for subsidy for the Direct Loan receivables is (\$657) million. The FFEL allowance is (\$9.6) billion as of September 30, 2003. The significant asset of the Federal Pell Grant Program is its Fund Balance with the Treasury, which consists of unexpended appropriations, the majority of which have been obligated for disbursement to eligible students.

FSA's liabilities of \$116.4 billion, as of September 30, 2003, consist mainly of \$91.8 billion in Treasury Debt for the Direct Loan Program. The FFEL Program has Liabilities for Loan Guarantees of \$15.4 billion and a Payable to Treasury of \$7 billion. This payable is for the amount of estimated liquidating fund future cash inflows in excess of outflows and for downward re-estimates of subsidy.

FSA's net position is \$5.2 billion, consisting of FFEL, Direct Loan, and Federal Pell Grant program unexpended appropriations of \$9.8 billion with negative cumulative results of operations of (\$4.6) billion. In accordance with credit reform, subsidy re-estimates are



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accrued for financial statement purposes but are not funded until a subsequent period; hence, the temporary negative cumulative results until funding is provided.

FSA's net cost of operations for the year ending September 30, 2003, was \$22 billion. The Direct Loan Program had a Total Net Cost of \$5.1 billion. In the FFEL Program, Total Net Cost was \$2.8 billion, which comprised approximately \$2.5 billion in subsidy expense with the remainder from other types of administrative and contractual service expenses. For the Federal Pell Grant Program, the Total Net Cost was \$14.1 billion. In addition, indirect costs incurred by the Department are allocated to each FSA program for financial reporting purposes.

Appropriations are made at the beginning of each fiscal year to cover the estimated losses on loans to be made or guaranteed during that year and for the Federal Pell Grant Program. Permanent indefinite appropriation authority is available to finance operations resulting from loan guarantees in years before FY 1992. For the FFEL and Direct Loan programs, an amount to cover the subsidy cost of each program as well as an amount to cover administrative expenses is appropriated. The Federal Pell Grant Program receives one appropriation that covers actual grant disbursements.

### MANAGEMENT CONTROLS AND LEGAL COMPLIANCE

FSA is committed to management excellence in administering federal student aid programs and to maintaining accountability for its annual performance. We are required to provide assurance that our financial systems and management controls adhere to applicable guidance and standards. During FY 2003, FSA has aligned its objectives and goals with those of the Department and has managed to improve its operations and correct weaknesses identified in the FY 2002 Report and its FY 2002 Financial Statement Report.

External audits by the General Accounting Office (GAO) and independent accounting firms, internal audits by the Office of Inspector General (OIG), and reviews by FSA program offices and others evaluate the adequacy and efficiency of the operations and systems of FSA and its partners to provide overall assurance that their business processes are functioning as intended. The audits and reviews also help ensure that management controls and financial management systems comply with the standards established by the FMFIA, Federal Financial Management and Improvement Act (FFMIA), Paperwork





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Reduction Act, Computer Security Act, and OMB Circulars A-123, A-127, A-130, and A-133.

Prior audits, reviews, studies and observations of daily operations have identified management control and financial integrity issues and weaknesses. Findings contained in prior audits and program reviews questioned the integrity of data recorded in the Department and FSA systems that play an integral part in FSA's accountability over student aid funds.

When audit reports are issued, program managers are required to develop corrective action plans. Progress on the plans is monitored throughout the year and program managers are held accountable for implementing the corrective action in as timely a manner as possible.

The following portion of this report describes actions we are taking to improve financial management integrity. We are also providing updates on compliance with legal requirements.

### INITIATIVES TO IMPROVE FINANCIAL INTEGRITY AND ACCOUNTABILITY

#### **Financial Integrity**

With the development and implementation of a fully integrated financial management system, FSA is better enabled to manage its financial operations and improve accountability over its resources.

The CFO is responsible for implementing an integrated financial management system that will monitor FSA's financial performance. The CIO provides the technical support for this effort, and the business unit GMs provide business level information and support. In FY 2003, the CFO's financial management goals were to ensure and promote financial integrity in Department and FSA programs.



## **Financial Management System (FMS)**

The FMS allows the FSA CFO to account for all FSA program transactions (e.g., FFEL, Pell Grant, and Direct Loan), to make payments, to perform funds control, and to create financial reports. FMS is the single point of financial information for FSA, integrating data from several sources. Accordingly, FMS provides consolidated data to support key management analysis and is the only place within the Department of Education to obtain a comprehensive financial picture of a school across all FSA programs.

During FY 2003, FSA completed a number of system initiatives designed to improve reconciliation procedures between systems. First, FSA completed the FMS to FMSS (the Department's Financial Management Support System) Data Transformation and Transfer initiative, greatly improving the link between the two systems, eliminating unnecessary process steps, reducing reconciliation time, and improving the efficiency of system processes. Second, FSA implemented a new Transaction ID that is shared between FMS, the Grant Administration and Payment System (GAPS), and Common Origination and Disbursement System (COD) and can be used to greatly improve reconciliation efforts between the systems. Last, FSA established daily transaction system balancing procedures between FMS, COD, and GAPS to ensure that the number and amount of each daily transaction batch received and posted by a system was equal to the number and amount sent by the feeder system. Monthly, we reconcile FMS to FMSS.

Daily transaction processing of all feeder files has been dramatically improved. For example, in last year's financial statement audit, significant delays in the processing of Direct Loan Servicing files were noted. In September 2003, the average processing time for Direct Loan Servicing data, measured from the time FMS receives the data to the time that it is sent to FMSS, was 10 hours, 35 minutes. FSA recently awarded a new performance-based FMS Operations contract, which has numerous performance measures on feeder transaction processing time that are tied to contract incentives and penalties. FSA anticipates that these incentives will help FSA maintain, or even reduce, the average processing times for feeder transactions.

During FY 2003, FMS security procedures were updated and documented to strengthen procedures in security and contingency plans. The FMS System Security Officer instituted improvements to user access control, trading partner agreements, security training, and disaster recovery testing, among other security procedures. These improvements are expected to win FMS and its supporting processes swift security certification and accreditation.





## **Reconciliations**

High priority was given in FY 2003 to sustaining the unqualified opinion on the financial statements. Performing reconciliations and analyses of the underlying data supporting account balances appearing in the financial statements was crucial to reaching that goal. A major goal for FSA was to improve the timeliness and quality of both the reconciliations and analyses performed. FSA consistently reconciled all operating partner activity to its FMS and the Department's general ledger within 30 days after month-end close throughout FY 2003, representing a 15-day improvement over the previous standard of 45 days. FSA drastically reduced the number of unmatched Fund Balance with Treasury records as compared to last year.

FSA also placed emphasis on performing more in-depth analyses during FY 2003. FSA performed a roll forward and additional reconciliations that were not performed the previous year; our flux analysis was much more detailed; and quarterly we analyzed what made up our balances. By undertaking improvements in reconciliations and analyses, users of the financial data were given added assurance of the integrity of financial data.

## **Internal Controls**

In addition to obtaining an unqualified opinion, FSA's goals were to demonstrate significant improvement over internal controls. Effective internal controls are essential to programmatic and financial stewardship and accountability in order to prevent waste, fraud, and abuse. In addition to the improvements noted above, in FY 2003 FSA was able to:

- Reduce reconciliation time for all FSA operating partner activity to FMS (FSA ledger) and to FMSS (Department's general ledger) to within 30 days of month-end close.
- Review accounting treatment to ensure compliance with Standard General Ledger accounting.
- Develop an account validation framework for system development and ongoing certification of accounting and program systems providing financial data.
- Develop the framework for measuring whether the accounting validation is successful by performing independent post-production.
- Develop trial balance capability for FSA operating partners to facilitate and expedite the reconciliation process.
- Strengthen FSA's financial reporting to ensure full compliance with OMB Circular A-124, Management Accountability and Control, and Credit Reform.



- Better prepare and review quarterly and annual financial statements.
- Remind schools of the requirement to complete verification of selected students for Pell Grant and Direct Loan disbursement data after the COD program was implemented.
- Improve the monitoring mechanism to reduce the repeat of prior material weaknesses and reportable conditions.

## **Payments**

For the past several years, FSA has performed an analysis to determine its estimate of erroneous payments to demonstrate that its program funds were materially spent in accordance with laws and regulations. This analysis was expanded to satisfy the annual OMB Circular A-11 (Section 57) reporting requirement. The Circular has been superseded by the Improper Payments Information Act of 2002 (P. L. 107-300). The Act provides guidance on identifying and reducing erroneous payments. Of the four steps agencies should take with respect to erroneous payments, FSA has completed the following three:

- Identified those programs and activities that are susceptible to significant erroneous payments.
- Implemented a plan to reduce erroneous payments.
- Reported estimates of the annual amount of erroneous payments in programs and activities and progress in reducing them.

The Act calls for a statistically valid estimate of the annual amount of erroneous payments in programs and activities. FSA has not completed this step and is working with the Department's Office of the Chief Financial Officer (OCFO) to identify what steps FSA will need to take to ensure compliance with the Act.

The federal student aid programs depend upon income and other information provided by applicants. This self-reporting has been a concern for FSA for many years because incorrect reporting, either by mistake or intent, can lead to underpayments and overpayments. FSA has a verification process in place to obtain supporting documentation from a selected number of applicants. However, because the process can be abused, FSA performs a data match with the IRS to determine the possible extent of applicant under- and over-reporting of income, the effect this would have on the disbursement of Pell grants, and how improvements can be made in targeting applicants for verification. FSA also uses the information when it estimates the total amount of erroneous payments in the federal student aid programs.





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FSA's erroneous payments rate is estimated to be less than 1.2%.<sup>1</sup> The majority of FSA's estimated erroneous payments consist of estimates of underpayments and overpayments based on the possible under- and over-reporting of applicant income. To address this issue, the Department, OMB, and the Treasury Department developed and submitted to Congress proposed legislation to authorize the matching of federal student aid applicant data to tax return data.

### Future Demands

The most important challenges facing FSA at this time are to:

- Continue to strengthen financial management to ensure FSA maintains an unqualified opinion.
- Meet the goals we have established that would remove the FSA programs from the GAO High-Risk List.
- Strengthen IT security through integration of FSA security and privacy architecture.
- Improve internal controls essential for reliable financial reporting and for protecting programs and operations from fraud, waste, and abuse.
- Develop and implement an integrated solution, Common Services for Borrowers (CSB), to manage and support the systems and operations that affect borrowers repaying their student loans.
- Implement, once legislation is passed, an efficient electronic solution and supporting business process for matching IRS income information with FSA applicant information, without degrading customer service to eligible applicants.

<sup>1</sup> This is the most conservative rate based on FSA's latest draft erroneous payment rate information. It assumes total FSA program payments of \$59.2 billion. If payments to lenders, guarantors, and schools, and consolidated loan amounts were included, the amount of total FSA program payments would increase to \$90.6 billion and the erroneous payment rate would drop to 0.8%. \$728 million is the draft total estimated erroneous payment amount. Of this amount, \$124 million is based on direct liabilities or system/administrative errors (\$119 million from program reviews, compliance audits, and OIG audits, and \$5 million from system errors). The rest is based on estimates (\$40 million in estimated erroneous loan discharges, \$356 million in estimated overpayments, and \$207 million in underpayments from a Pell IRS match study).





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### GAO High-Risk List

GAO believes that the FSA programs have been successful in providing students with access to funds for postsecondary education but have been less successful in protecting the financial interests of the federal government and the U.S. taxpayers. Thus, the FSA programs have been designated as high risk since GAO's initial report, and the programs once again received that designation in its most recent report (January 2003).

FSA recognizes that providing billions of dollars of grants and loans through thousands of intermediaries to millions of students who may not be credit-worthy is inherently risky. However, FSA is committed to demonstrating that it is aggressively managing this challenge in a manner that ensures access to postsecondary education while reducing the vulnerability of student aid programs to fraud, waste, error, and mismanagement. In a May 2003 letter to GAO, the Secretary noted that the Department was pleased with the progress made to reduce the vulnerability of fraud in the programs and felt strongly that the current risk in the programs did not rise to the level of being designated a federal high-risk program. The Department felt it had plans in place to address the issues raised by GAO in the January 2003 designation, and it believed that the fact that the Department and FSA received unqualified opinions on their FY 2002 financial statement audits should be considered. Largely because of the remaining financial management issues, GAO declined to commit to reconsider its January 2003 decision to classify the FSA programs as high risk. GAO also did not want to set precedent for an out-of-cycle assessment/designation, and it wanted to be sure that the financial management improvements were sustained over time.

Although GAO denied the Secretary's request, the Department remains steadfast in its belief that by continually focusing on the President's Management Agenda initiatives, a strategic driver in both the Department and FSA's performance plans, the FSA programs will be removed from the high-risk list during the next biennial assessment. We have a plan in place, and we achieved a major milestone by receiving an unqualified opinion on our financial statements for two successive fiscal years. This achievement confirms that our plan is working and should be instrumental in demonstrating the sustainment of sound financial management, a GAO prerequisite for the removal of the high-risk designation.



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### LEGAL COMPLIANCE

#### **The Federal Managers' Financial Integrity Act (FMFIA), Sections 2 and 4, Management Control and Financial Management Systems**

In FY 2002, FSA recommended to the Department that it continue reporting the following weaknesses as part of the annual FMFIA update:

- Quality of data needed to support management decisions.
- Foreign school recertification.
- Inadequate FFEL financial management system.

Through the implementation of corrective action plans developed by program managers, in FY 2003 the Department determined that these weaknesses are no longer considered material. Also, FSA did not identify any new material weaknesses under FMFIA during FY 2003.

#### **Federal Financial Management Improvement Act (FFMIA)**

The FFMIA requires federal agencies to report on agency substantial compliance with federal financial management system requirements, federal accounting standards, and the U.S. Government Standard General Ledger. FSA complied with FFMIA for FY 2003.

##### Limitations of the Financial Statements

The financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with U.S. generally accepted accounting principles (GAAP) for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.



**F E D E R A L  
S T U D E N T A I D**

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# **PART II**

## **PERFORMANCE SECTION**





## F E D E R A L S T U D E N T A I D

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### FISCAL YEAR 2003 FEDERAL STUDENT AID ANNUAL PERFORMANCE REPORT

#### Introduction

In 1998 Congress amended the HEA, creating a PBO for the delivery of federal student financial assistance. Since then, FSA has set out to address the four statutory goals for the PBO in its annual performance plans. Those goals are:

- Improve service to students and other participants in the federal student aid programs, including making the programs more understandable to students and their parents (Goal 1).
- Reduce the cost of administering the programs (Goal 2).
- Improve and integrate the information delivery systems that support programs (Goal 3).
- Develop an open, common, and integrated delivery system and information system for the programs (Goal 4).

#### Business Operations

FSA's mission is to help put America through school. Through federal grant and loan programs administered by FSA, millions of students who might not otherwise have access have been able to pursue a postsecondary education. The Federal Pell Grant, FFEL, Direct Loan, LEAP/SLEAP, and Campus-Based programs are the largest source of student aid in the United States, providing a total of approximately \$60 billion in new aid to nearly nine million postsecondary students in FY 2003. FSA's FY 2003 fiscal year high-level program volume statistics are provided in Part I, Management's Discussion and Analysis. In addition, a few key FY 2003 business operations statistics are provided below:

- Processed 13 million FAFSA forms for academic year 2003-2004.
- Processed nearly 26 million Direct Loan payments from borrowers.
- Handled nearly 36 million inbound and outbound customer service calls across all call centers.



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### FY 2003 Performance Plan

FSA's FY 2003 Annual Performance Plan was developed under the leadership of a new COO and involved the participation of all levels of staff within the organization. Under COO Terri Shaw, the organization developed and adopted five objectives consistent with the government-wide strategies and initiatives outlined in the President's Management Agenda, the Department of Education's Strategic Plan, and the issues responsible for the inclusion of the federal student aid programs on the GAO High-Risk List. Most important, these objectives are also closely aligned to the four PBO statutory goals identified above. The objectives are:

- Integrate FSA systems and provide new technology solutions (aligned with Goal 1 and Goal 4).
- Improve program integrity (aligned with Goal 2 and Goal 3).
- Reduce program administration costs (aligned with Goal 3).
- Improve human capital management (supports all goals).
- Improve products and services to provide better customer service (aligned with Goal 1).

The development of the FY 2003 Annual Performance Plan identified 18 priority projects representing the entire organization's efforts to achieve the stated objectives. The projects were also specifically weighted for urgency and value to assure that they were important to 1) the business of providing aid to applicants; 2) getting an unqualified opinion on the financial statements; and/or 3) getting the FSA programs off of GAO's High-Risk List. The priority projects are listed in Exhibit A, along with their end-of-year completion status.

### HIGHLIGHTS OF FSA'S FY 2003 PERFORMANCE

During FY 2003, FSA improved products and services and achieved concrete results in integration and program integrity. At the same time, while maintaining FY 2002 operating budget levels, the organization improved its human capital management to meet tomorrow's federal aid delivery needs. Highlights of the most important results and outcomes are discussed below by objective.





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### **OBJECTIVE ONE – INTEGRATE FSA SYSTEMS AND PROVIDE NEW TECHNOLOGY SOLUTIONS**

FSA is continuing to provide appropriate and integrated technology solutions that enable the delivery of federal student aid in an efficient and cost-effective manner. We have developed and are executing a multi-year plan to integrate and improve our systems. Projects in the FY 2003 Performance Plan deliver visible and direct results for students, schools, and financial partners. Our e-commerce strategy is aimed at reducing the cost of delivery of financial aid to each student by making our business process faster, less error-prone, and less labor intensive, while at the same time improving the quality of service to customers. FSA accomplished the goals it set out to achieve. Of these, the most notable include the following.

#### **Enterprise Data Strategy**

In FY 2003, FSA committed to delivering an overall approach for streamlining and integrating systems to ensure that accurate and consistent data are exchanged between our customers, partners, and compliance/oversight organizations. The purpose of the Enterprise Data Strategy is to define FSA's enterprise data vision and plan for how it will combine the tools, techniques, and processes to manage its enterprise data needs. It will address the following data concerns: 1) business flow of data across the enterprise; 2) data structure and architecture; 3) primary ownership; 4) standards; 5) management and governance; 6) access methods; and 7) quality and integrity. This strategy is fundamental to our future technology investments.

Specifically, the strategy focuses on consolidating the various data strategy components—including technical strategies, student and institution common identifier strategies, access and enrollment management, and the XML strategy—into a comprehensive strategic vision. The target state of the strategy has three main components: 1) business process changes; 2) common data architecture; and 3) a technology strategy that supports the integration of processes and data to provide an enterprise solution for FSA.

The strategy will include high-level implementation and sequencing plans, which will define the order and alignment of those systems that require re-engineering and business process integration. In addition, the strategy will help deliver improved quality and service to customers and enable better management decisions, creating a more responsive and cost-efficient organization.

Although the strategy and high-level implementation plan were not final until November





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2003, many important major milestones were met that are noteworthy to this report. Documents that were completed include:

- Data-centric view of the “As-Is” FSA system Data Flows.
- A Data Quality Report that highlights the high-priority data quality issues.
- Technical Strategies recommendations for Web Services, Internal and External Data Exchange, and Data Storage and Access Management solutions needed to support the future needs of the organization.
- XML Strategic Assessment and Enterprise Vision and XML Core Component Dictionaries that are included in the Department’s overall Data Architecture.
- High level design for the Single Student Identification Method.
- Routing Identification (RID) options analysis to allow FSA to identify and associate Trading Partner Institutions with other related entities.
- Enrollment and Access management objectives and high-level requirements for reducing/managing multiple user ID’s and passwords.

### **Recipient Financial Management System (RFMS) and Direct Loan Origination System (DLOS)**

Implemented in April 2002, the COD system became operational, integrating the origination and disbursement processes for two of FSA’s largest student financial aid programs, Pell Grants and Direct Loans. The processing systems that handled processing before COD were RFMS and DLOS. Those systems were not retired immediately after COD began processing due to the differences between the Pell Grant and the Direct Loan programs, their relative complexity, and the fact that for the first time two \$10 billion programs would be processed on the same platform. To mitigate potential risk, these system retirements and associated timeframes were planned as part of the COD contract management and development process. Accomplishing this project means that FSA has gone from two systems to one system for processing its largest two programs, which together account for almost half the program funding administered by the Department.

### **Lender Application Process (LAP) and Lender Reporting System (LaRS)**

The LAP system, which became operational last fiscal year, allows prospective lenders and servicers to request enrollment in the FFEL Program and provides online verification and updating of demographic data for existing FFEL Program lenders and servicers. The LaRS, which became operational this year, automates the Interest and Special Allowance Request (Formerly ED Form 799) and supports an electronic integrated business application for managing the lender payment process. LAP/LaRS was designed and



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developed last year to support a centralized, controllable, and consistent accounting process for lender payment management. Prior to the development of these systems, thousands of lenders requested payments through an inefficient paper-driven, front-end process. These new systems directly contribute to erroneous payment risk reduction and meet government mandates for electronic processing of payments. The stabilization of the LAP/LaRS system that was performed in FY 2003 included operational support, data validation, change request management, and the design, development, testing, and implementation of application fixes, changes, and enhancements.

### **Form 2000**

The Form 2000 project, known as the Guaranty Agency Financial Report (GAFR) was originally implemented in October 2000. Since the initial implementation, the Guaranty Agency (GA) community and the FSA users, developers, and operators have identified and requested a number of enhancements to the system. The 2003 GAFR enhancements include system functionality that allows monthly, quarterly, and annual GAFR submissions, additional soft and hard edits to help ensure data consistency, the ability for GA's to create amended annual entries, and the creation of a custom conversion and interface to transfer annual GAFR transaction data to the FSA subledger in order to create annual report journal entries. These enhancements will give GA's more control over data submission, improve data accuracy, and improve audit trails and internal controls by providing and supporting increased financial oversight of default collection activities, reimbursement claims, and portfolio status.

### **eZ-Audit**

eZ-Audit is a new Web-based application that provides schools a single point of submission for financial statements and compliance audits to the Department. The school simply signs on to eZ-Audit, enters summary audit and financial data into a Web form, attaches an electronic version of its report, and clicks the submit button. eZ-Audit strengthens internal management controls through the electronic submission, storage, and secure access of compliance audits and financial statements. The electronic data capture minimizes processing errors, reduces paper, and eliminates lost documents. The automated workflow decreases backlogs, shortens cycle times, and helps to balance resources.





## **Common Services for Borrowers (CSB)**

FSA took significant steps to implement the integration of its borrower back-end support systems and business processes. In an effort to improve loan portfolio management, FSA conducted market research, listened to industry professionals, took a commercial approach, and decided to combine borrower-related functions into an integrated process known as CSB.

In FY 2003, FSA initiated a competitive procurement for CSB to incorporate our three major loan servicing systems and customer service functions (including the Direct Loan Servicing System, the Debt Collection Management System, and the Direct Loan Consolidation System) into a more efficient, cost effective, and customer-centric model. This procurement was conducted using a two-phase source selection procedure, in accordance with applicable federal procurement laws and regulations and FSA's procurement flexibility statute (20 U.S.C. 1018a(d)).

It has been determined that CSB will improve FSA's loan portfolio management and yield significant cost savings, significant customer service improvements, and significant business process improvements. The vision to improve the management of student aid obligations owned by the Government will be accomplished by streamlining the current contract systems and operations under a single contract. This re-engineering effort will drive operational efficiencies, reduce unit cost, and improve customer satisfaction through integrated business processes. The scheduled contract award is in November 2003.

## **Debt Management and Collection System (DMCS)**

The current DMCS environment comprises a 13-year old mainframe system, 72 interfaces, and over 15 stand-alone sub-systems. The objective of the DMCS re-engineering project is to modernize the existing collection processes to be more aligned with the commercial sector and to replace the existing collection systems with a leading edge debt recovery management solution. This will strengthen FSA's ability to manage the collections portfolio. The DMCS re-engineering project was incorporated into the Common Services for Borrowers solicitation.

## **Electronic PLUS Master Promissory Note**

The electronic PLUS Master Promissory Note (MPN) project was undertaken to provide an electronic option for parents borrowing through the Direct Loan Program. FSA now offers an electronic multi-year promissory note alternative for all three sub-programs of the





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Direct Loan Program. A Web-based electronic MPN option was developed in 2001 for subsidized and unsubsidized Direct Loans made to student borrowers. This supplemental implementation extends that capability to parent borrowers.



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### OBJECTIVE TWO – IMPROVE PROGRAM INTEGRITY

FSA is continually working to improve program integrity. It is committed to demonstrating that it is aggressively managing the federal student aid programs in a manner that ensures access to postsecondary education while reducing vulnerability to fraud, waste, and abuse. We made great improvements in demonstrating sound financial management by strengthening our internal controls and financial management systems, including supporting processes and procedures, so that reliable and timely information is available to manage FSA's day-to-day business operations. Our program integrity efforts continue to be aimed at maintaining a balanced approach to minimize noncompliance and default rates, while still promoting the widespread use of the programs. Specific accomplishments follow.

#### Unqualified Audit Opinion

FSA accomplished one of its priority goals and received an unqualified opinion on its FY 2002 financial statements. An unqualified opinion had not been received in several years. In addition, the FY 2002 Internal Control Report identified only one material weakness and noted improvements. FSA's commitment to demonstrating sound financial management is its top priority. The Department successfully deployed the Joint Financial Management Improvement Project compliant Oracle Federal Financials in January 2002. In FY 2003 many important enhancements were completed. The new system offers real-time information coupled with the ability to produce timely financial statements. The Secretary's management improvement initiative continues to focus high-level attention on FSA's remaining management improvement initiatives. These actions represent significant progress toward the Department's objectives for improved financial management, reporting, accountability, and an unqualified opinion. In preparation for FY 2004 accelerated year-end reporting, the Department is further refining its audit preparation plans and tightening its closing process.

#### GAO High-Risk List

FSA faces a management challenge as it provides billions of dollars of grants and loans through thousands of intermediaries to millions of students who may not yet have established credit. Since 1990, GAO has reported on government programs and functions that it has identified as "high-risk" because of their greater vulnerabilities to fraud, waste, abuse, and mismanagement. GAO designated the federal student aid programs as high-risk in its initial report, and it has continued to give the programs this designation. A primary management goal of the Secretary is to remove FSA's programs from GAO's list of high-



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risk programs. The Secretary and the COO are committed to the permanent removal of the FSA programs from this list and to demonstrating that FSA is effectively managing the inherent risks of the programs. The receipt of the unqualified opinion on the FY 2002 financial statement audit was a critical accomplishment towards this goal, although it was not received in time to be considered by GAO prior to its January 2003 designation of the FSA programs as high-risk.

In May 2003, Secretary Rod Paige made a formal request to GAO for a mid-cycle reconsideration of the high-risk designation based on demonstrable progress made in addressing the issues that had caused the FSA programs to be designated as high-risk. On June 9, 2003, GAO denied the Secretary's request, primarily because at the time of the designation GAO did not have sufficient evidence of the Department sustaining financial management improvement. In responding to GAO in July 2003, the Secretary, though disappointed, recognized that by working toward this goal the Department continues to build a foundation for management excellence that will benefit it and its programs for many years. Improvements have been made in financial management and in the strategic management of human capital. In addition, better management of IT resources is improving services for customers and partners, and FSA is modernizing to improve program integrity.

FSA will continue to follow GAO's guidance document, *Determining Performance and Accountability Challenges and High Risks* (GAO-01-159SP), to address the issues raised by GAO in the high-risk designation. In FY 2003, FSA accomplished key activities that were aimed at addressing these issues, and we continued to use them as a priority as we finalized our FY 2004 Annual Performance Plan. We are committed to working with GAO staff to ensure that they are informed of our progress toward resolving Department management issues and sustaining improvement in the FSA programs so that a positive assessment will be received in the GAO High-Risk Update Report, scheduled to be issued in January 2005.

### Internal Controls

In addition to obtaining an unqualified opinion, FSA made significant improvement over internal controls. Effective internal controls are essential to programmatic and financial stewardship and accountability in order to prevent waste, fraud, and abuse. In FY 2003, FSA was able to:

- Reduce reconciliation time for all FSA operating partner activity to FMS (FSA ledger) and to FMSS (Department's general ledger) to within 30 days of month-end close.





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- Review all accounting treatment to ensure compliance with standard general ledger accounting.
- Develop account validation framework for system development and ongoing certification of accounting and program systems providing financial data.
- Develop the framework for measuring whether the accounting validation is successful by performing independent post-production.
- Develop trial balance capability for FSA operating partners to facilitate and expedite the reconciliation process.
- Strengthen FSA's financial reporting to ensure full compliance with OMB Circular A-124, Management Accountability and Control, and Credit Reform.
- Better prepare and review quarterly and annual financial statements.
- Remind schools of the requirement to complete verification of selected students for Pell Grant and Direct Loan disbursement data after the COD program was implemented.
- Improve the monitoring mechanism to reduce the occurrence of prior material weaknesses and reportable conditions.

### **Reconciliation Operational Procedures**

In order to identify improvements and fill gaps in the procedures related to reconciliation, FSA School Delivery Services staff collaborated with the COD Customer Service Representatives, systems contractors, CFO/FMS, and OCFO GAPS staff continually throughout FY 2003. This collaborative work led to several system releases and hundreds of incremental improvements made during daily and weekly conference calls. As a result, processing, reconciliation, and year-end closeout were easier for both schools and FSA.

### **Default Management and Prevention Strategies**

In July 2003, a new function for portfolio risk management within Borrowers Services became operational. The unit, the Portfolio Risk Management Group, was created to provide an organizational focus to better support a fully integrated approach and provide designated resources to student loan default management and prevention strategy management. This new unit formalizes the FSA focus on mitigating loss in the loan programs.

In FY 2002, the Department identified strategies for default management and prevention activities to: 1) improve default prevention, 2) improve recipient and school eligibility, and 3) improve default collection. During this fiscal year, the Portfolio Risk Management Group worked with other FSA Service representatives to conduct an even more



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comprehensive inventory analysis of the existing default prevention activities across the organization, identifying and validating FSA-wide default prevention strategy areas. This group also identified the three top-risk attributes for default:

- The borrower did not complete the program of study.
- A correct telephone number for the borrower was not available.
- The borrower could not be contacted for 12 months (360 days delinquent prior to transfer to FSA's Debt Collection Service).

FSA's debt strategy is one that emphasizes mitigating risk through portfolio management and appropriate use of tools for default prevention. In FY 2003, due diligence efforts were implemented that have a focus on effectiveness; they include increasing contact efforts for high-balance delinquent accounts. Outreach efforts such as conferences with guaranty agencies, lenders, and schools to share best practices in this area, and debt management partnership with the National Council of Higher Education Loan Programs continue to demonstrate that default prevention is a high priority for FSA.

An additional accomplishment in this area was the Late Stage Delinquency Assistance Program, an initiative that was implemented this year to mitigate potential default in the Direct Loan Program. The purpose of the program is to elicit assistance from schools in locating and contacting borrowers prior to the borrower going into default. Initial results are promising.

### **Default Collections**

FSA has continued to effectively manage the default portfolio, which is shown by FSA's ability to exceed the FY 2003 collections goal. The FSA default portfolio was \$13.975 billion at the beginning of FY 2003. During FY 2003, default collections, excluding consolidations, totaled nearly \$1.33 billion. The result was a recovery rate of 9.5 percent, far above the FY 2003 goal of 7.6 percent. In addition to realizing a record year for combined recoveries on debts owed by individuals, FSA saw higher collections by private collection agencies this year than in previous years. Total default recoveries, including recoveries by the GA's, exceeded \$5 billion in FY 2003 for the third year in a row. Over \$350 million has been collected by matching the entire defaulted loan portfolio with the National Directory of New Hires, a database that contains employment and income information on all persons employed in the United States. This enables the





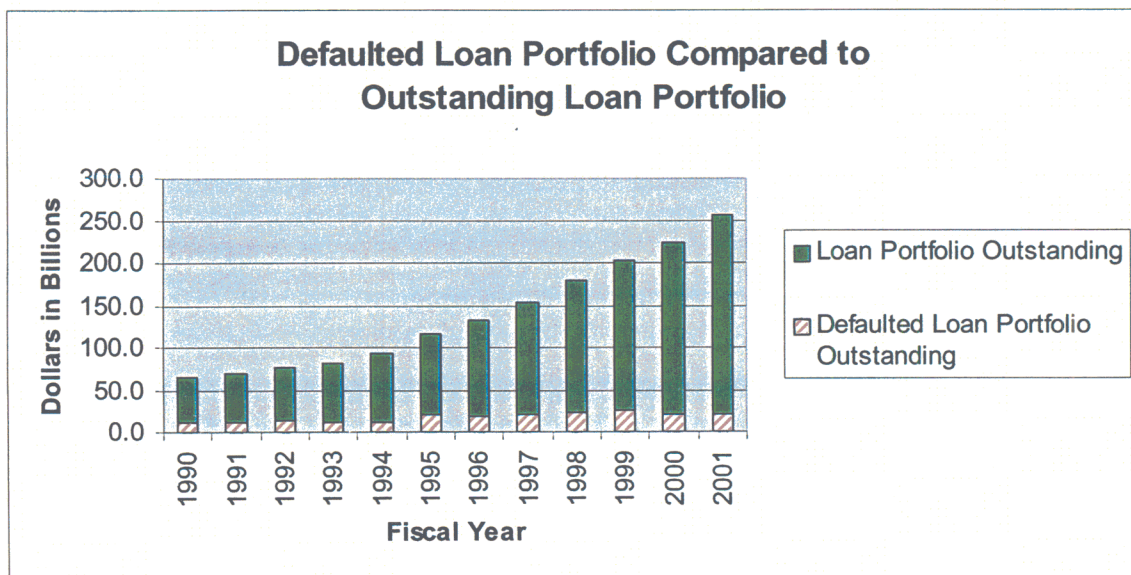
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Department to find current addresses for more than two million defaulters. Other achievements in default recovery include:

- \$700 million through federal income tax refunds and other federal offsets.
- \$470 million through wage garnishment of defaulters.
- \$2 billion by consolidating defaulted loans.
- \$900 million gained through loan rehabilitation.
- \$980 million through regular collection.

The following chart is an indication of our continued success in this area. As the value of the FFEL and Direct Loan portfolio has risen, the percent attributed to the defaulted portfolio has dropped.



### Cohort Default Rate (CDR)

The CDR, a major indicator of our accomplishments under our default management and prevention strategies, continues to decrease. It reached an all-time low of 5.4 percent for the FY 2001 rate, which represents the most current data available. The FY 2001 cohort default rate is a snapshot in time of borrowers who began repaying their loans between October 1, 2000 and September 30, 2001 and who defaulted before September 30, 2002. In addition, for the first time ever, all schools have rates low enough to ensure they remain eligible for federal financial aid programs. (In the last decade, nearly 1,200 schools have

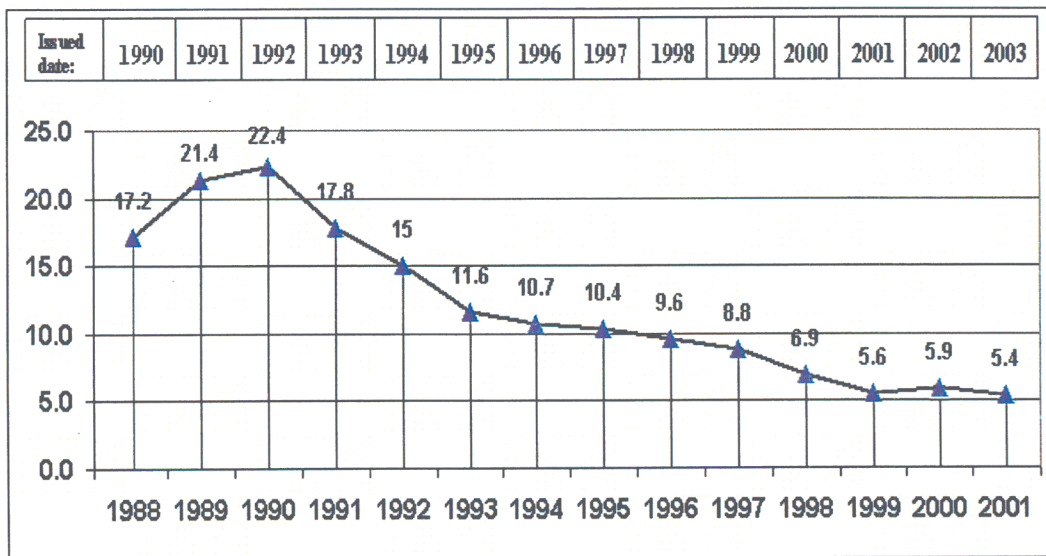




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lost eligibility to participate in the federal loan programs due to their high default rates.) Credit for this accomplishment is shared with the financial aid community, which improved its efforts to counsel borrowers and to inform them of the numerous flexible repayment options designed to meet individual repayment needs. Also, the 1998 Amendments to the HEA extended by three months—from 180 days to 270 days—the length of time it takes a delinquent borrower to default on a student loan. The effect of this change was first felt with the release of the FY 1998 cohort default rates, which decreased by 1.9% from the FY 1997 rates, with approximately half of the decrease being attributed to the time extension. For the last three years, with the release of the FY 1999, 2000, and 2001 rates, the change in default date has been fully implemented. As the chart below demonstrates, the national cohort default rate has dropped nearly every year since 1990, when it peaked at 22.4 percent.



### Oversight and Compliance Measures

FSA has been criticized by GAO and the Inspector General (IG) for not being able to demonstrate it has a balanced management approach to school oversight and compliance.



In order to address this issue, FSA developed measures to demonstrate the effectiveness of FSA's monitoring strategy. The measures include:

- Monitoring of institutions and program dollars.
- Monitoring of overall compliance.
- Managing risk.
- Providing technical assistance to schools new to the FSA Programs.

In FY 2003, 2,544 schools (40 percent of all schools participating in the FSA Programs) were monitored through a comprehensive review. These schools comprise 40 percent of all program dollars. Four percent of all schools received an on-site program review, and one percent of schools received an on-site compliance improvement visit. In FY 2003, the total number of schools having a risk probability greater than 80 percent in FSA's school risk assessment system was 558, or 9 percent of all schools participating in the FSA programs. In addition, the total funding of schools having a risk probability greater than 80 percent equaled nearly \$2.3 billion, or 4 percent of all program dollars. In future years, FSA will trend this type of information, as well as the recently developed oversight and compliance measures, to demonstrate the effectiveness of FSA's monitoring strategy or to identify where improvements can be made.

### **Financial Partners Data Mart**

The first two releases of the Financial Partners Data Mart created a central repository to accomplish the following functions: risk management, customer relationship management, compliance management, and portfolio management. This year's release of the Data Mart, which is its third phase, enables FSA to assess program risk areas, evaluates FFEL participation through a risk model or scorecard, and raises efficiencies in the lender and guaranty agency oversight and monitoring process. The new enhancements also provide access to lenders, allowing them to have access to only their designated information and to a select list of reports.

### **Guaranty Agency and Lender/Servicer Risk Management Guides**

FSA developed new interim guaranty agency and lender/servicer program review guides in an effort to continue to enhance oversight and improve consistency and risk management. This was done in partnership with the financial aid community. As a result, FSA is now able to obtain more information to use in review planning prior to going on-site, including electronically submitted documents from the entities. As a result, reviewers are able to analyze and determine areas of risk or concern much earlier than before. Because these



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guides were developed with input from the financial aid community, the establishment of clear expectations concerning the review scope and process has resulted in a more effective work environment with the organization being reviewed.

### **Overall FSA Security and Privacy Architecture**

A major challenge in developing security and privacy architecture is determining the proper level and means of authentication to provide a safe and secure environment for borrowers, schools, and financial partners to conduct their transactions. For FY 2003, the goal was to define an overall vision to guide planning and development of FSA security and privacy technical services and components. Implementing an enterprise security architecture for FSA will ensure that systems are developed and maintained in accordance with Federal requirements and will employ controls that ensure the public trust.





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### **OBJECTIVE THREE – REDUCE PROGRAM ADMINISTRATION COSTS**

As FSA continues to receive level-funded operating budgets, the reduction of program administration costs is one of the most challenging objectives before us. FSA is focused on linking performance to budget decisions and improving performance tracking and management. Ultimately, the goal is to further improve control over resources and to maintain greater accountability for their results. Although in FY 2003 other priorities kept FSA from measuring our costs to determine whether we were progressing towards our statutory goal of reducing administrative costs, this was still an important driving strategy as we identified the activities for our FY 2003 Annual Plan. A few activities that supported this objective in FY 2003 follow.

#### **Budget and Contracts**

In recent years FSA has been able to maintain a relatively flat operating budget while supporting continued increases in program volume and workload, so that it could make IT investments. FSA's ability to manage and control operating expenses is based on a philosophy of good fiscal management and continual process improvement to increase productivity and operational efficiencies, coupled with innovation in our products, services, and supporting technologies. In FY 2003, FSA developed and implemented processes and procedures to better manage how it initiates, renews, and extends contracts. These processes and procedures are designed to help ensure that FSA receives the highest value service for the lowest possible cost.

#### **Executive Dashboard**

Cost management is being accomplished by establishing a set of metrics to measure performance and productivity trends across the enterprise over time. These metrics will guide improvement initiatives that optimize the return on investment and reduce costs. In FY 2003, FSA developed the Executive Dashboard, which provides management a weekly view of operational metrics, budget, contracts productivity, and performance metrics at the aggregate and service delivery level. The Dashboard is shared across the organization on a weekly basis so that all FSA employees can measure the progress they are making as an organization toward their objectives and goals.



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### Electronic Products and Processes

In recent years FSA has converted several paper processes and services into electronic formats, which result in savings. The results of these processes and services for FY 2003 are as follows:

- Nearly 7.7 million *FAFSA on the Web* applications were processed in FY 2003, compared to 5.8 million last year. This represents a 33 percent increase in electronic processing of student aid applications.
- COD processed approximately 30 million records for approximately six million student borrowers and grant recipients in its first year of operation (as of April 29, 2003).
- 1-800-4-FED-AID, the Federal Student Aid Information Center, received over 7 million calls this year. Service levels have increased with 99 percent of calls completed, a 3.1 percentage point increase over last year, and the average speed to answer reduced by 66.1 percent to nine seconds.
- As of September 30, 2003, there were 602,036 Direct Loan borrowers enrolled in Electronic Debit Account (EDA), an increase from its first year of 54,884 borrowers in FY 1999. The federal government has saved over six million dollars since the inception of the EDA program.
- In August 2003, FSA implemented a new cost saving process to receive electronic change of address records from the U.S. Postal Service rather than through paper postcards. Direct Loan Servicing receives an average of 1.5 million postcards annually. At a cost of \$0.70 per post card, FSA pays the Post Office up to \$21,000 per month. The new electronic postcards will reduce costs by approximately 70 percent.



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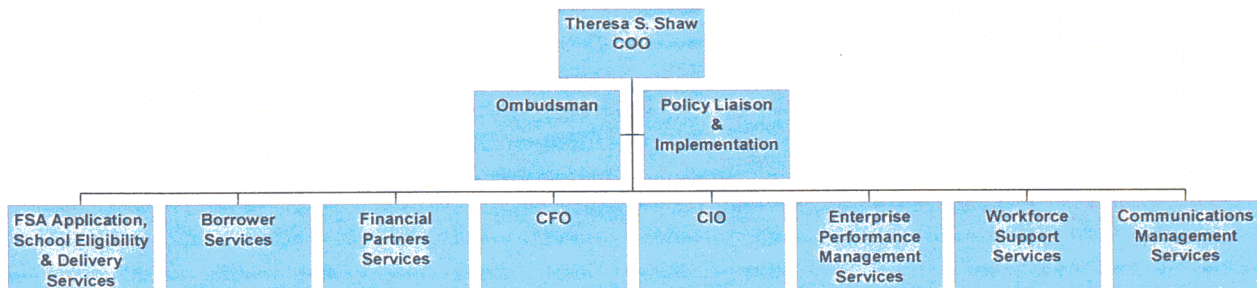
### OBJECTIVE FOUR – IMPROVE HUMAN CAPITAL MANAGEMENT

FSA has made substantial progress in building, sustaining, and effectively deploying a skilled, knowledgeable, diverse, and high-performing workforce that is aligned with FSA's objectives. In addition, FSA employees have worked on several One-ED and other human capital improvement projects that the Department has prioritized in the Strategic Plan to address the President's Management Agenda Human Capital Management Initiative. A few key human capital management accomplishments in FY 2003 follow.

#### Reorganization

The COO proposed a new functional organization structure for FSA that is aligned with FSA's strategic drivers, business objectives, and operational goals. This new organization structure was approved by the Department and implemented on July 13, 2003.

#### FSA ORGANIZATION STRUCTURE



Under the new structure, FSA is an organization:

- In which people are empowered to get things done.
- That fosters and expects continual innovation and learning.
- That is fluid and readily adaptable to business changes.
- That attracts and retains top talent for employment.
- In which the inherent risks of the programs are effectively managed.





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### Succession Planning

FSA recognizes the importance of developing succession-planning options that produce excellent leadership teams and ensure continuity of exceptional management. In 2001, GAO identified strategic human capital management as a government-wide challenge and in April 2002 GAO specifically recommended that FSA implement a succession plan (*Federal Student Aid: Additional Management Improvements Would Clarify Strategic Direction and Enhance Accountability GAO-02-255*). In conjunction with the Office of Management, FSA Workforce Support Services conducted an analysis of its vulnerability due to the retirement of key officials. Through this effort, Administration and Workforce Support Services identified 241 employees who are or will become eligible for retirement before the end of calendar year 2006. Working closely with FSA management, Administration and Workforce Support Services determined that 169 of those employees were in key positions that, if vacated, could disrupt FSA's ability to accomplish its mission. To ensure minimal disruption, they identified 117 employees with the qualifications to fill behind these key positions, and they developed a strategy for filling behind the remaining 52 positions. That strategy includes, but is not limited to, detail assignments to temporarily fill behind the retiring employees until the positions can be recruited for and filled permanently.

### Employee Training

FSA continued to provide employees with the support and training opportunities necessary to achieve its mission. Training courses such as *Solution Life Cycle Development*, *COD*, *Introduction to Enterprise Application*, and *System Security* provided staff an overview of the technologies used in the modernization of FSA. Training sessions entitled *Leadership Excellence* were delivered to all FSA managers to further the development of strong leaders in FSA who will lead the organization in meeting its performance objectives. Specific attention was paid to collaborating for results and performance management.



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### OBJECTIVE FIVE – IMPROVE PRODUCTS AND SERVICES TO PROVIDE BETTER CUSTOMER SERVICE

#### Customer Satisfaction Surveys

This year FSA resumed use of the American Customer Satisfaction Index (ACSI) survey methodology to measure the customer satisfaction of FSA's most high profile, frequently used products and services. The ACSI uses a widely accepted methodology to obtain standardized customer satisfaction information; it is used by 180 companies in 29 industries representing about 75 percent of the nation's economy. The products and services that were surveyed were *FAFSA on the Web*, Direct Loan Servicing, COD, and LaRS. The results follow.

FSA PRODUCT OR SERVICE	ACSI SCORE
FAFSA on the Web	86
Direct Loan Servicing	77
COD	66
LaRS	71

The National ACSI benchmark for the private sector is 74, and the Federal Government benchmark is 70. The *FAFSA on the Web* score is exceptional and approaches Amazon.com's score of 88, which is ACSI's highest score ever obtained. Both *FAFSA on the Web* and Direct Loan Servicing, the only two components for which prior satisfaction information is available, showed an improvement of three points and eight points, respectively, from their 2001 ACSI scores. Scores for LaRS and COD are lower but are in line with business-to-business satisfaction results, which range from 65-74 for banking and telecommunications firms.

#### Electronic Products

In FY 2003, FSA improved and employed greater usage of currently available electronic products:

- The eZ-Audit was introduced in April 2003 allowing schools to submit their financial statements and compliance audit data online. This Web-based application benefits schools because the forms are pre-populated with demographic information on the school, and there is automatic error checking prior to a



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submission, instant acknowledgement of receipt after submission, no copying and mailing costs, and 24/7 access to their reports and electronic data.

- Beginning this year with the release of the FY 2001 CDRs, FSA transmits CDR notification packages to schools electronically via the Student Aid Internet Gateway (SAIG). This electronic process replaces the paper notification process for all Title IV schools located within the United States.
- Based on feedback from institutions participating in the federal student aid programs, FSA began an initiative to move more PC-based software to the Web. Development is nearly complete on two Web products, and testing will begin in October 2003.
- In March 2003, FSA launched "FSA for Counselors," an online student aid resource for middle school, secondary school, and TRIO counselors. Features include the High School Counselor's Handbook, federal student aid publications, videoconferences, and scripts and slides for presenting a financial aid night.
- In July 2003, a Dear Colleague Letter was posted to the Information for Financial Aid Professionals (IFAP) Web site announcing the new MPN for the Federal Perkins Loan Program. The Perkins MPN is designed as a multi-year, multi-loan promissory note for students. Generally, as long as the student and the school do not change, a new note is not required. This MPN is optional for the 2003-2004 school year and will become mandatory beginning November 2004.
- In July 2003, Direct Loan Consolidation received the first Electronic Verification Certifications (EVC) from lenders. They are used in the purchase of federally insured student loans for Direct Loan Consolidation. The new Web-based EVC allows lenders to log on to a secured Web site and either complete EVC's online or download and upload a batch file to collect EVC data from their loan-holder systems.
- Finally, the Government Paperwork Elimination Act requirement to provide the public an electronic alternative to all paper transactions has been virtually completed.

### **President's Management Agenda e-Gov Initiatives**

The goal of FSA's participation in the e-Gov initiatives is to make it easier for borrowers and partners to receive high quality service by expanding the federal government's effective use of electronic technologies. This includes support of IT projects that offer performance gains across agency boundaries, such as eLoans and students.gov. Another example of an e-Gov initiative is GovBenefits, whose goal is to reach out to the public and ensure they know about available programs within the Department and across the government. The result of this initiative is higher visibility of programs to those citizens





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who could use the assistance. The FSA team performed a substantial amount of work in FY 2003 to increase the number accessible via the Web site. At the beginning of FY 2003, the Department had 23 programs on the Web site, and now there are 64 education programs on the GovBenefits.gov Web site. In addition, FSA assists the Department as the managing partner for the eLoans initiative and manages the cross-agency Web portal, students.gov.



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### OMBUDSMAN'S REPORT

The FSA Student Loan Ombudsman works directly with student loan borrowers, loan holders, and schools in an informal dispute resolution process. The range of complaints, from simple questions to complex long-term problems, can inform future FSA activity as well as changes to the student aid programs overall. Issues resulting from the complaints are summarized and shared both internally and externally and are considered when addressing the need for systemic changes. The office heard from 17,664 complainants in FY 2003, an approximate 6 percent increase over the 16,707 for FY 2002. Of those, 3,621 required intense research and facilitation of outcomes on longstanding issues, an approximate 9 percent increase from the 3,305 in FY 2002.

The bulk of the Ombudsman activity involves disputes in which an Ombudsman specialist works with the borrower, loan holder, schools, and other parties to gather facts, establish a common understanding of the problem, and work toward resolution. Cases involve all loan and school types. It often takes 60-90 days to thoroughly research the underlying issues on these cases.

For the first three years of operations (FY 2000-FY 2002) the most prevalent category was "Account Balance." In FY 2003, "Loan Cancellation/Discharge" dominated the research questions. The top five case issues, in order of frequency, were:

- Loan Cancellation/Discharge (e.g., dispute ineligibility).
- Account Balance (e.g., too high, incorrect).
- Repayment Plans/Amounts (e.g., needs more options).
- Consolidation (e.g., borrower wants to consolidate).
- Default (e.g., cannot make payments).

Issues are tracked to inform FSA leadership and loan holders so that corrective action can be taken to prevent similar situations and so that the potential for program change can be evaluated.

New for FY 2003 was sharing the case information with the Customer Service Review Board that FSA put into place to review what FSA customers are telling us at all levels. The long-term results should be fewer Ombudsman cases as the Board works to address the systemic issues raised.



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Effectiveness of the case activity is measured through customer comment and through an OMB-approved weekly survey. Borrowers whose cases closed recently are chosen at random and asked to respond to questions on Ombudsman service accessibility, knowledge of representatives, timeliness of resolution, level of satisfaction with resolution, and overall Ombudsman service. On a scale of 1-5, where 1 is the *highest* possible rating, the FY 2003 rating from customers with single-issue questions was 1.81. The higher rating of 1.50 was for the research cases that take more time to resolve and involve more direct customer contact.

### LEGISLATIVE RECOMMENDATIONS

The Department of Education continues to believe that routine data matches with the IRS would strengthen the financial integrity of the student aid programs. FSA, OPE, and legislative affairs offices are collaborating with staff from OMB and Treasury, as they work with congressional committees (to date the Joint Committee on Taxation and House Ways & Means) on proposed legislative language that would amend the Internal Revenue Code to accomplish this objective. The matches would allow the verification of applicant income information submitted on the student aid form (the FAFSA) with information from official income tax records.

FSA will continue to make suggestions and offer advice on any legislative recommendations the Administration prepares for reauthorization of the HEA.

### POSITIONING FOR THE FUTURE

FSA has drafted its FY 2004-2008 Five-Year Plan, supported by an Integrated Business and System Sequencing Plan that contains the details of our projects and initiatives. The draft Five-Year Plan establishes tactical goals for achieving each of our strategic objectives, which were once again validated by FSA senior leadership in the FY 2004 planning process. We believe that the plan will provide useful information to our stakeholders and Congress that can be used to hold us accountable and measure our progress. This plan will be provided to the community for comment in the first quarter of FY 2004. It highlights the projects FSA has undertaken, or will undertake, that deliver the most visible and direct impact for students, schools, and financial partners. Our goal to





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transform FSA systems is reiterated in the plan—to make FSA technology processes Web-enabled, and our systems integrated and consolidated. The Enterprise Data Strategy continues to be the cornerstone of the plan to support an integrated, simplified business and technical model that will allow students, schools, and financial partners to access the information they need, when they need it—on paper, by telephone, and over the Internet—in a secure manner that addresses appropriate privacy concerns.

For FY 2004, the following work priorities remain for FSA: 1) continuing to run our operations to ensure students are provided the funds to support their higher education; 2) sustaining our financial management improvements; 3) addressing the issues to remove the student aid programs from the GAO High-Risk List; 4) integrating the remaining legacy systems and their ultimate migration to newer technology solutions; and 5) developing and implementing workforce alignment initiatives to support FSA performance goals and the Department's One-ED objectives. In addition, an important FY 2004 priority will be to better measure and report on our administrative costs to determine whether we are progressing towards our goal of reduced administrative costs in our business processes. FSA's success in implementing these action items will directly contribute to greater employee productivity, accountability, and morale, better operational systems, increased program integrity, reduced program costs, and—ultimately—improved products and services for our customers.

FSA is committed to providing access to postsecondary education by providing the right money, to the right people, at the right time, and at the right cost. The results of this year's Performance Plan are proof of that commitment. There were many successes in FY 2003. Based on these successes, 19 bonuses were awarded to the COO and the senior managers in FSA. A bonus of \$72,500 was awarded to the COO. Eighteen bonuses were awarded to other senior managers of FSA. These awards ranged from \$33,844 (23.75 percent of annual salary) to \$3,756 (4.38 percent of annual salary), with a median award of \$12,540 (11.13 percent of annual salary).

We intend to continuously identify issues and develop solutions in support of our mission to help put America through school. We are confident that with the availability of sufficient resources our efforts will result in improvements in all aspects of our operations and services.



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## Exhibit A PERFORMANCE PLAN STATUS AT A GLANCE

*As of September 30, 2003*

FSA No.	Indicator	Final Status
1	Obtain an unqualified ("clean") opinion on FSA's financial statements	✓
2 *	Develop and execute an FY 2003 plan for removal from the GAO High-Risk List	✓
3	Reconcile FSA accounts to Department's general ledger within 30 days after month-end close by 9/30/03	✓
4	Implement the proper accounting structure and appropriate internal controls in all systems impacted by FSA's system integration and technology solution initiatives	✓
5	Develop trial balance capability for each operating partner (ACS, Raytheon, EDS, COD) to facilitate and expedite the reconciliation process	✓
6	Address material weaknesses and reportable conditions in audits	✓
7	Implement Form 2000 enhancements needed since original deployment in October 2000	✓
8	Determine the scope of the Debt Management Collection System (DMCS) re-engineering	✓
9	Improve school's fund management, reconciliation, and closeout processes	✓
10	Stabilize the Lender Application Process (LAP) and Lender Reporting System (LaRS)	✓
11	Enhance Program Monitoring and Oversight	✓
12	Develop and standardize an integrated contract management approach that utilizes performance measures that are directly linked to the business case objectives	Continued in FY 2004
13	Create an Enterprise-level dashboard of productivity and performance metrics	✓
14	Develop and/or implement workforce alignment (business processes, skills, etc.) initiatives and actions to support FSA performance goals and One-ED objectives	Continued in FY 2004
15	Implement integrated project management oversight for FSA's system integration initiatives	✓
16	Define an enterprise-wide data strategy and high-level implementation approach that addresses the business flow of data across the enterprise, architecture, primary ownership, standards, management, access methods, and quality	Continued in FY 2004
17	Analyze Personal Identification Number (PIN) issues related to enterprise wide management/architecture strategy	✓
18	Create an overall FSA integrated security and privacy architecture	✓

Key:



Completed

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Performance project completed but project success measure not met.



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## **PART III**

## **FINANCIAL SECTION**





**F E D E R A L  
S T U D E N T A I D**

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## **A MESSAGE FROM THE CHIEF FINANCIAL OFFICER**



**FEDERAL  
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CHIEF FINANCIAL OFFICER

November 12, 2003

Dear Colleagues in the Student Financial Assistance Programs:

The Office of Federal Student Aid (FSA) wishes to express its appreciation to the Office of the Inspector General and our auditors for their cooperative efforts to timely resolve potential issues, leading to an unqualified opinion on the Consolidated and FSA financial statements for Fiscal Year (FY) 2003.

FSA made significant progress in addressing its audit issues from previous years. We were able to develop improved procedures and analyses in order to eliminate FSA's material weakness related to reconciliation and analysis. It has been our priority in FSA to address our audit issues in order to achieve and maintain our unqualified ("clean") opinion. As a result of maintaining our unqualified opinion, we now expect to be able to demonstrate to why it is time for the FSA programs to be removed from the General Accounting Office (GAO) High-Risk list.

The FSA Chief Financial Office, in conjunction with each of our program areas and General Managers, was able to implement improved controls over our numerous feeder systems maintained by our operating partners. Specifically, we were able to:

- Reconcile consistently all FSA Operating Partner activity to FSA's financial management system (FMS) and ultimately to our financial statements within 30 days of month-end closing.
- Perform new and more in-depth analyses of our financial data. For example, FSA now performs a rollforward and additional reconciliations that were not performed last year; our flux analysis is much more detailed; we regularly analyze our account balances to provide management with reasonable assurance of the validity of the balances appearing in the financial statements.
- Complete a number of initiatives aimed at improving reconciliation procedures between systems such as the FMS to FMSS (the Department's Financial Management Support System). This greatly improved the link between the two systems, eliminating unnecessary process steps, reducing reconciliation time, and improving efficiency of system processes. A new Transaction ID was developed, greatly improving the reconciliation efforts between FMS, the Grant Administration and Payment System (GAPS), and Common Origination and Disbursement (COD). We also established daily transaction system balancing procedures between FMS, COD, and GAPS to ensure that the number and amount

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- of each daily transaction batch received and posted by a system is equal to the number and amount sent by the feeder system.
- Enhance Forms 2000 to improve data accuracy and to facilitate the systems monthly reconciliation to the Department's General Ledger.
- Identify and correct many systemic issues in processing our financial activity between the operating partners, FSA, the Department, and the Department of the Treasury. We were able to significantly reduce the number of unmatched Fund With Treasury Balance records amount.
- Stabilize the Lender Application Process (LAP) and Lender Reporting System (LaRS) through deploying the lender payment portion of the system as well as reconfiguring lock box and providing help desk support.

We are pleased that we were able to make significant improvements by strengthening internal controls over our financial management processes and eliminate the material weakness reported in last year's report.

FSA is committed to maintaining this unqualified opinion in future fiscal years. We look forward to working with the Office of Inspector General and our auditors to make FSA a model for an outstanding performance-based organization and a place where the highest quality management business practices exist.

Sincerely,

A handwritten signature in black ink, appearing to read 'Victoria L. Bateman', with a long horizontal flourish extending to the right.

Victoria L. Bateman, CPA, CGFM





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## Report of Independent Auditors

## Report of Independent Auditors

To the Inspector General  
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of FSA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FSA as of September 30, 2003 and 2002, and its net cost, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management Discussion and Analysis of FSA and the Supplemental Information is not a required part of the basic financial statements but is supplementary information required by Office of Management and Budget Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with Government Auditing Standards, we have also issued our reports dated November 12, 2003, on our consideration of FSA's internal control over financial

**Report of Independent Auditors**

Page 2

reporting and on our tests of its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audits.

*Ernst & Young LLP*

November 12, 2003  
Washington, D.C.





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## Report on Internal Control

## Report on Internal Control

To the Inspector General  
U.S. Department of Education

We have audited the consolidated balance sheets of the Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department), as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended, and have issued our report thereon dated November 12, 2003.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audits, we considered FSA's internal control over financial reporting by obtaining an understanding of FSA's internal control, determined whether this internal control had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal control relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

In addition, with respect to internal control related to performance measures reported in the Management Discussion and Analysis of FSA's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 01-02, reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of

**Report on Internal Control**

Page 2

internal control that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the specific internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We noted certain matters discussed in the following paragraphs involving the internal control and its operation that we consider to be reportable conditions. However, none of the reportable conditions is believed to be a material weakness. The remainder of this report details the reportable conditions.

FSA relies on the Department's Office of Chief Financial Officer (OCFO) to provide support for FSA's financial reporting needs. Specifically, FSA has a memorandum of understanding (MOU) with OCFO that indicates that OCFO is responsible for the following: (1) preparing FSA's financial statements; (2) performing the daily operations of processing transactions in the general ledger; (3) preparing the required financial reporting to the Office of Management and Budget and the U.S. Department of the Treasury, such as the SF-133 and the SF-224; and (4) developing and distributing accounting policies and procedures.

In addition, under the MOU, FSA is responsible for: (1) implementing accounting policies and procedures; (2) coordinating with OCFO and Budget Service on all financial reporting issues; and (3) reconciling subsidiary ledgers to supporting documentation and ledgers.

**REPORTABLE CONDITIONS****1. Improvements of Credit Reform Estimation and Financial Reporting Processes are Needed (Modified Repeat Condition)**

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements were made over the last several years, we noted that the management controls surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined and implemented earlier



**Report on Internal Control**

Page 3

in the process to ensure that appropriate estimates are prepared. OMB Circular A-123 defines management controls as “the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making.”

We noted that the Department and FSA made some progress on this reportable condition during FY 2003, including improving the process used to develop required financial statement disclosures, continuing a process to study and adjust key assumptions in the subsidy models, and ultimately involving a broader array of Department managers in critiquing the process and results. A key focus for FY 2004 and beyond is to further refine and document these processes and ensure that such input and critique occurs throughout the year. A well-defined process includes appropriate and robust checks and edits, as well as documentation of key decisions and rationales. Such a process is buttressed by input and substantive involvement by FSA financial, program and as appropriate trading partner management responsible for the programs and data inputs, as well as the OCFO and Budget Service. Process review controls should be in place and performed before adjustments are recorded or made available for use in making program management decisions. Many of the elements of this process were implemented late in the year, and provide a framework for further improvement throughout FY 2004.

During our testing of loan guarantees, allowance for subsidy, and subsidy costs estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long-term cost for the FFEL loan program is reflected in the financial statements through periodic charges for subsidy and recognition of liabilities for loan guarantees. The Department uses a computer-based cash flow projection model and OMB calculator to calculate subsidy estimates related to the program that are then recorded in the liability account. The model uses multiple sources of loan data and hundreds of assumptions. In 2003, the Department performed a review of key assumptions used in the model in such areas as interest benefits, collections, defaults, consolidations, etc. These reviews were in part performed based on certain tools developed by the Department to help validate the output of the credit reform model. For example, the Department uses a standard actuarial technique of “back casting” the subsidy estimates against actual results to research the relationships in the data. In the prior year, this analysis indicated that actual results were varying from the credit reform model output in such areas as interest benefits and collections. In other instances additional assumptions were developed based on improved data gathering capabilities. Based on this review, changes to the assumptions were developed to calculate the subsidy re-estimates which had a related financial statement impact. We

**Report on Internal Control**  
Page 4

noted that there was initially insufficient documentation explaining the basis for developing and selecting the revised assumptions and validating the reasonableness of the resultant output. Some of this documentation was subsequently developed in connection with the audit process. This lack of documentation complicated the review process performed by OCFO, FSA and Budget Service.

- The high volume of activity, multiple sources of data, and sensitivity of assumptions used to record subsidy cost subject the liability and other credit reform related accounts to a significant level of inherent risk of misstatement. We noted several issues that the Department and FSA must continue to take into consideration regarding the accuracy of the assumptions and data used in the model. We noted that initial outputs of the model indicated unusual results from those that occurred in the prior year. As a result of subsequent reviews undertaken by the Department and FSA, it was determined that, in certain instances, incorrect data was queried to develop assumptions. Standard operational review and signoff of credit reform work products would help alleviate these conditions. The current analytical tools and account analysis procedures used by the Department (like the “back casting” technique described above) are not sufficiently developed to help highlight and explain unusual variations based on the model output. This is particularly the case with the direct loan program for which sufficient historical data has not yet been accumulated.
- The model, as currently specified, is based on multiple inputs and assumptions. While the nuances of the loan programs and presumed interrelationships with economic and other factors lead to much of the complexity, a more simplified approach might well provide estimates in a reasonable range, recognize the imperfections in the data and reduce the possibility of computational errors. Given the numerous model inputs, interpreting its output leads to protracted analysis to explain the resulting output. In addition, the complexity of the model greatly increases the likelihood for computational errors that on balance may not be meaningful to the final estimate. While the approach we suggest might not in the short-term substitute for the existing model, in the interim it might provide a useful analytic tool to challenge at least the directional results of the existing model, and provide support that the computations are appropriate within an order of magnitude.
- The mechanics of credit reform accounting process are such that the new “cost” of a consolidated loan is budgeted in the year the consolidation occurs, but the effects in terms of assumed repayment for the existing loans are recorded currently based on when the projected consolidation will occur. With the significant increase in consolidations in the last four years, the Department and FSA must closely monitor and critically assess unusual patterns or changes from anticipated results that are attributable to the impact of loan consolidation assumptions. In FY 2003, the Department completed an analysis of consolidation activity. In the analysis, the



**Report on Internal Control**

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Department was able to link cash flows from new consolidated loans to the paid-off underlying loans. As a result of this analysis, the Department was able to refine assumptions for the pattern and timing of consolidation into new FFEL loans and Direct loans. The Department should continue to monitor the actual results against estimates for the consolidation loan prepayment assumption to determine if further refinements are necessary. While this study enhanced the Department's and FSA's understanding of consolidation activity, and was used as a model input in FY 2003, additional data should still be obtained and evaluated for consolidation activity. Currently, FSA's estimates for collections and disbursements combine cash transactions and consolidations. To properly assess the impact of consolidations on the subsidy costs of the loan programs, separate estimates and comparison to actual results should be made for consolidation and cash activity. Since the credit reform budgetary and accounting treatment as described above can be viewed as not closely tracking the economic substance of the loan programs, particularly in the case of consolidations of defaulted loans which may have a high expected "re-default" rate, we encourage the Department to consider developing and communicating credit reform estimates with alternative scenarios and assumptions.

- Refreshing the model for changes in program participant behavior is a continuing challenge, as is surfacing related issues for potential, legislative, regulatory or policy actions. The Department and FSA should formalize processes to identify changes in usage by schools, lenders, servicers, guaranty agencies and borrowers which have the ultimate impact of extending the period of interest subsidy, delaying or transferring default costs between the programs and activities which encourage students to avail themselves of benefits inherent in the design of the programs, or otherwise impact the absolute and relative costs of the loan programs. Modeling the result of such behavioral changes timely will allow the Department and FSA to more accurately estimate subsidy costs. For example, during 2003 the Department changed its assumptions for deferments after several years of indicated patterns of higher usage of such loan features.
- We noted that during FY 2003 adjustments were recorded to the liability for loan guarantees and allowance for subsidy accounts that are not required based on how the ending balances in these accounts are determined. These adjustments add to the complexity in the monitoring of balances in these accounts. These adjustments would indicate that additional business rules should be developed and documented for the types of adjustments and frequency of adjustments that should be recorded to these accounts.
- Formalized written procedures are needed to improve communication between OCFO, FSA and Budget Service in monitoring loan estimation accounts, performing routine quality assurance and validation checks of account activity, preparing



**Report on Internal Control**

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supporting documents for adjustments, or providing explanation for changes from one year to next in the loan liability and allowance for subsidy estimates. During FY 2003, we noted some improvement in the sharing of loan estimation information among the three organizations. For example, the three organizations worked together in reviewing the data produced by the credit reform model and the resulting financial statement adjustments and disclosures. We noted that this process was informal and not well developed to accomplish the important task of fully reviewing the output generated from the credit reform estimation process. Further, this process was not always performed in a timely manner that is critical in the preparation of the financial statements to meet future reporting deadlines. We did note that this review did identify several instances where data was either incorrectly used in the credit reform model or where assumptions could be improved. Without formal written policies and procedures, FSA increases its risk that financial reporting and loan model estimates are not properly executed to achieve management and program objectives.

**Recommendations:**

We recommend that Federal Student Aid perform the following:

1. Preparation of accurate and timely direct loan and loan guarantee subsidy estimates must be a joint effort between Budget Service, OCFO and FSA. The three organizations should collectively develop a business process that assigns both primary and secondary responsibility for developing subsidy estimates and assumptions, and the timely review of the output of the credit reform estimation model. It is important that this process and the results of each review be documented.
2. An important component of the credit reform estimation process is the development of key assumptions used in the model. A formal process should be used to document the development and approval of each key assumption used, as well as the need for the development of new assumptions. This should be an ongoing annual process with key constituents, such as FSA, Budget Service, OCFO, and others as appropriate, involved early each fiscal year so that agreement can be reached on areas for which additional study is required. An important part of this process is to expose such assumptions to critical assessment by Department management and other interested parties in a transparent manner, and develop decision rules regarding when such assumptions are to be changed based on actual results, program revisions, behavioral changes, or the availability of additional data. For key assumptions, transmittal of the credit reform estimates should be accompanied by an analysis of alternative scenarios and assumptions.
3. FSA should coordinate with the Department to continue to identify and gather data to better monitor and report on consolidations, and accelerate studies to validate the

**Report on Internal Control**

Page 7

basis of assumptions used to determine the effect of loan consolidations, income contingent loan repayment terms, and fixed rate consolidation offers to ensure that subsidy models are updated timely for the best available information.

4. Improve the analytic tools used to monitor direct loans and FFEL, including refining the direct loan backcast and forecast comparison to actual results process, developing analytic tools to validate the appropriateness of the subsidy allowance for direct loans, and improving the analytic tools used to monitor FFEL activity to increase their sensitivity in identifying unusual relationships.
5. The credit reform process should be documented to show the flow of information used, procedures used to develop assumptions and review and approval processes. Further, this documentation should include the automated calculation models, edit processes and quality control measures used in the process. In addition, business rules should be developed and documented to show the types and frequency of adjustments recorded to the liability for loan guarantees and allowance for subsidy accounts.
6. The use of somewhat simplified credit reform models should be explored. Such models might at a minimum be useful tools to verify the directional and order of magnitude appropriateness of outputs from the existing model, and at the margin might well produce estimates which are sufficiently precise to meet the requirements for credit reform reporting for financial and budgetary purposes, augmented if necessary by special studies.

**2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)**

In connection with the annual audit of FSA's fiscal year 2003 financial statements, we conducted a controls review of the information technology (IT) processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

The Office of Inspector General reported in the September 2003 audit report, *Department of Education's Implementation of FISMA* (control number ED-OIG/A11-D0003), that the Department has made significant progress in addressing control weaknesses identified in



**Report on Internal Control**

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prior audits. OIG has reported that the Department has made progress in several areas, including: finalizing certain documents that support the agency-wide Information Security Program and Certification and Accreditation program; beginning security testing and evaluation of certain systems; beginning the implementation of the computer security incident response program; implementing procedures to periodically test information security controls for certain of the Department's systems, and beginning the installation of intrusion detection systems.

Although significant progress has been made with respect to information technology controls, our work and the OIG findings reinforce that continuous effort is needed to further address control weaknesses related to information technology and systems. In particular, the following suggestions for improvements were noted for technical security controls at the Department and FSA:

- The Department's mission critical servers need to be consistently updated with the latest application version updates, virus/data integrity protection packages, and security patches.
- Certain mission critical systems need to be tested for platform and database level common security vulnerabilities and exposures.
- The use of complex passwords should be enforced on all systems across the enterprise.
- Network and host based intrusion detection systems should be deployed to provide meaningful alerts of potential network intrusions and malicious internal network activity.
- Firewall rules should be implemented to logically segregate database servers containing sensitive data from web servers within the web-hosting environment.
- Access controls should be implemented to protect certain mission critical systems from the contractor's untrusted internal networks.
- Security weaknesses identified in prior OIG security reviews should be fully corrected at contractor facilities.

**Recommendation:**

The Department concurs with the findings issued by the Office of Inspector General's September 2003 audit report, *Department of Education's Implementation of FISMA* (audit control number ED-OIG/A11-D0003) and has corrected some of the weaknesses cited in the report. We recommend that the Department continue efforts to address the security weakness identified by the OIG's FISMA report. Specifically, Federal Student Aid should coordinate with the Department to implement actions to address the issues outlined above.



**Report on Internal Control**  
Page 9**OTHER MATTERS:***Additional Improvement Needed in Financial Reporting Processes to Meet Continuing Accelerated Deadlines*

We noted significant improvements in FSA's financial reporting and account analysis processes compared to prior years. However, the ongoing acceleration of information due to OMB will require additional improvements. Beginning with the second quarter of FY 2004, management will be required to submit quarterly interim financial statements within 21 days after the end of the quarter as part of the requirements of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. In addition, year-end audited financial statements will be due November 15 beginning in FY 2004.

While FSA and the Department have made improvements and were able to accelerate the FY 2003 year-end financial statement preparation process significantly from prior years, we noted several areas where improvements can still be made. These areas include assessing the time frames used for completion of monthly reconciliations as well as the close out of the general ledger and financial statement preparation process. For FY 2003, the Department's internal guidelines indicated that reconciliations prepared within 45 days of month-end were considered timely. Given the ongoing acceleration in the time frame for submission of interim and year-end financial information to OMB and others, the current guidelines do not appear to be sufficient to effectively meet FY 2004 submission requirements. In addition, FSA should coordinate with the Department to examine processes and time frames for closing out the general ledger and preparing financial statements. We noted that management shortened the time frames for providing financial statements from approximately 45 days for June financial statements to 17 days for September draft financial statements. Given the increasingly limited time to provide financial statements to OMB on a quarterly basis, implementing additional procedures to sustain the time frames used at the end of FY 2003 appears warranted. In addition, FSA and the Department should update and document the procedures developed for the FY 2003 accelerated year-end financial statement preparation process, and assess areas for further improvement. One key estimate, the mid session review Credit Reform estimate, results in significant entries to the financial records, and as discussed earlier, a robust process to develop and review this estimate before it is recorded will significantly enhance the ability of FSA to meet the accelerated deadlines on an ongoing basis.

**Recommendation:**

1. Federal Student Aid should coordinate with the Department to review, update, and document the approach to financial reporting used for the FY 2003 year-end financial statements so that this approach will enable management to meet the accelerated due

**Report on Internal Control**  
 Page 10

dates for interim and year-end financial reports required by OMB. Such an approach may include assessing the need to accelerate procedures for the monthly general ledger close, financial statement preparation, reconciliations, account analysis and other significant financial management activities. The timeliness of receipt of critical information from guaranty agencies, lenders, grantees and other program participants should also be addressed.

**STATUS OF PRIOR YEAR FINDINGS**

In the reports on the results of the fiscal year 2002 audit of the Federal Student Aid financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

**Figure 1: Summary of FY 2002 Material Weaknesses and Reportable Conditions**

Issue Area	Summary Control Issues	FY 2003 Status
Financial Management, Reconciliations and Account Analysis Need to Be Strengthened (Material Weakness)	Significant financial management issues continue to impair FSA's ability to accumulate, analyze, and present reliable financial information. These weaknesses are primarily due to deficiencies in certain of the Department's and FSA's financial management practices, including inadequate reconciliations and account analysis early in FY 2002. Issues associated with the transition to a new financial management system in FY 2002 also contributed to difficulties in these areas.	Not Considered a Material Weakness – Issues Reported in the Reportable Condition on Credit Reform, Other Matters or in the Management Letter
Improvement of Financial Reporting Related to Credit Reform is Needed (Reportable Condition)	Management controls and analysis need to be strengthened over financial reporting related to credit reform.	Improvements Noted – Modified Repeat Condition Reportable Condition
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements Noted – Modified Repeat Condition Reportable Condition

**Report on Internal Control**  
Page 11

We have reviewed our findings and recommendations with FSA management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 12, 2003.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

*Ernst & Young LLP*

November 12, 2003  
Washington, D.C.





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## Report on Compliance with Laws and Regulations

## Report on Compliance with Laws and Regulations

To the Inspector General  
U.S. Department of Education

We have audited the consolidated balance sheets of the Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended, and have issued our report thereon dated November 12, 2003.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of FSA is responsible for complying with laws and regulations applicable to the entity. As part of obtaining reasonable assurance about whether the entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to FSA.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards or OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether FSA's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. FSA relies on the Department's systems to provide support for FSA's financial reporting needs, including utilizing the Department's general ledger to process transactions. We have identified the following instance of noncompliance:

**Report on Compliance with Laws and Regulations**

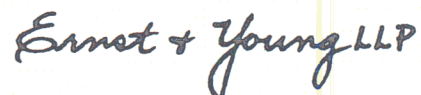
Page 2

The Department has made progress in strengthening controls over information technology processes during FY 2003. However, our work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses over information technology security and systems that need to be addressed. With respect to technical security controls and security management, the Department needs to test certain mission critical systems for platform and database level common security vulnerabilities and exposures, implement access controls to protect certain mission critical systems, consistently update mission critical servers with the latest application version updates, virus/data integrity protection packages, and security patches, deploy certain detection systems to provide meaningful alerts of network intrusions, implement firewall rules to segregate database servers containing sensitive data from web servers, and fully correct security weaknesses at contractor facilities identified in prior OIG security reviews. The Department believes that they have made sufficient progress in resolving previously identified IT security weaknesses in order to remove the IT Security Program as a material weakness in its FY 2003 Federal Managers' Financial Integrity Act report; however, they acknowledge that IT security material weaknesses remain under the Federal Information Security Management Act and related IT security laws and regulations.

The Report on Internal Control includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and to the extent findings and recommendations were noted in prior years has provided a proposed action plan to the Office of Inspector General in accordance with applicable Department directives.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.



November 12, 2003  
Washington, D.C.

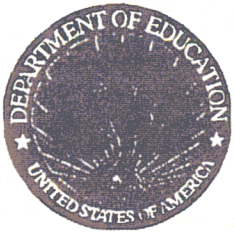




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## Management's Response



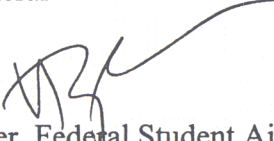
# UNITED STATES DEPARTMENT OF EDUCATION

*Federal Student Aid  
Chief Financial Officer*

## MEMORANDUM

November 10, 2003

TO: Thomas A. Carter  
Deputy Inspector General

FROM: Victoria L. Bateman   
Chief Financial Officer, Federal Student Aid

Subject: DRAFT AUDIT REPORTS  
Fiscal Years 2003 and 2002 Financial Statement Audit  
U.S. Department of Education ED-OIG/A17D0007

Federal Student Aid (FSA) wishes to express our appreciation for the efforts and professionalism of the Office of the Inspector General and our auditors, Ernst and Young (EY), in their audit of our Fiscal Year (FY) 2003 financial statements. We concur with your findings. FSA is committed to maintaining an unqualified opinion in future fiscal years and has prioritized several action items to eliminate reportable conditions and other matters as noted in this report.

FSA will continue to address the reportable condition related to credit reform. We recognize that significant additional work and process and procedure definition remains to be accomplished in order for the Department to have a fully institutionalized practice. FSA, OCFO and Budget Service will work together, as recommended by EY, to address the six recommendations outlined in the Internal Control Report. FSA has committed the staff and budget resources, including contracting with external credit reform experts, which we anticipate will be required to eliminate this reportable condition. Beginning in December 2003, FSA will work with OCFO and Budget Service on a comprehensive review of the current credit reform model, key assumptions, and outputs. This review will include participation and input from FSA program managers to determine if the current key assumptions continue to be appropriate for estimating the costs of the loan programs and the identification of any alternative key assumptions that may be used to provide improved estimates. Additionally, FSA will review the credit reform models used by other credit agencies to inform our review and simplification of the Department's model.

FSA will continue to address the reportable condition related to IT security. In response to the FISMA audit report, all corrective action items with respect to the VDC will be completed by 12/31/03. Additional improvements and corrective action items are in process for FY 2004.

Once again, we thank the Office of the Inspector General and EY for their efforts to complete a successful audit of FSA's financial statements and internal controls.



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# Fiscal Year 2003 Financial Statements and Notes



**United States Department of Education**  
**Federal Student Aid**  
**Consolidated Balance Sheet**  
**For the Periods Ended September 30, 2003 and 2002**  
(Dollars in Thousands)

	Fiscal Year 2003	Fiscal Year 2002
<b>Assets:</b>		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	\$22,736,259	\$21,938,736
Accounts Receivable		4,488
Total Intragovernmental	22,736,259	21,943,224
Cash and Other Monetary Assets (Note 3)	1,107,485	1,204,527
Accounts Receivable, Net	153,685	176,080
Credit Program Receivables, Net (Note 4)	97,614,657	91,326,667
General Property, Plant and Equipment, Net	16,857	16,028
Other Assets	38,816	38,737
<b>Total Assets</b>	<b>\$121,667,759</b>	<b>\$114,705,263</b>
<b>Liabilities:</b>		
Intragovernmental:		
Accounts Payable	\$3,924	\$11,474
Treasury Debt (Note 5)	91,786,731	89,497,870
Guaranty Agency Federal and Restricted Funds Due to Treasury (Note 3)	1,107,481	1,169,107
Payable to Treasury (Note 6)	7,022,995	4,713,206
Other Intragovernmental Liabilities (Note 7)	772	4,539
Total Intragovernmental	99,921,903	95,396,196
Accounts Payable	198,714	238,102
Accrued Grant Liability (Note 9)	550,739	749,376
Liabilities for Loan Guarantees (Note 4)	15,431,715	11,679,393
Federal Employee and Veterans' Benefits	5,369	4,277
Other Liabilities (Note 7)	319,528	322,887
<b>Total Liabilities</b>	<b>\$116,427,968</b>	<b>\$108,390,231</b>
Commitments and Contingencies (Note 15)		
<b>Net Position:</b>		
Unexpended Appropriations (Note 10)	\$9,813,595	\$10,225,861
Cumulative Results of Operations (Note 10)	(4,573,804)	(3,910,829)
<b>Total Net Position</b>	<b>\$5,239,791</b>	<b>\$6,315,032</b>
<b>Total Liabilities and Net Position</b>	<b>\$121,667,759</b>	<b>\$114,705,263</b>

The accompanying notes are an integral part of these statements.

United States Department of Education  
Federal Student Aid  
Consolidated Statement of Net Cost  
For the Periods Ended September 30, 2003 and 2002

(Dollars in Thousands)

	Fiscal Year 2003	Fiscal Year 2002
<b>Program Costs</b>		
<b>Program A (Enhancement of Post Secondary and Adult Education)</b>		
Intragovernmental Gross Costs	\$6,568,899	\$6,276,055
Less: Intragovernmental Earned Revenue	1,533,817	1,387,783
<i>Intragovernmental Net Costs</i>	5,035,082	4,888,272
 Gross Costs with the Public	 21,950,314	 18,286,566
Less: Earned Revenues from the Public	4,954,244	4,744,212
<i>Net Costs with the Public</i>	16,996,070	13,542,354
 <b>Program A Total Net Cost</b>	 \$22,031,152	 \$18,430,626
 <b>Net Cost of Operations</b>	 \$22,031,152	 \$18,430,626

The accompanying notes are an integral part of these statements.

**United States Department of Education**  
**Federal Student Aid**  
**Consolidated Statement of Changes in Net Position**  
**For the Periods Ended September 30, 2003 and 2002**

(Dollars in Thousands)

	Fiscal Year 2003		Fiscal Year 2002	
	Cumulative Results	Unexpended Appropriations	Cumulative Results	Unexpended Appropriations
Beginning Balance	\$(3,910,830)	\$10,225,861	\$(2,114,625)	\$8,738,795
Beginning Balance, As Adjusted	\$(3,910,830)	\$10,225,861	\$(2,114,625)	\$8,738,795
Budgetary Financing Sources				
Appropriations Received		\$25,353,248		\$18,426,874
Appropriations Transferred - In/Out (+/-)		(14,699)		
Other Adjustments (+/-)		(572,369)		(21,203)
Appropriations Used	\$25,178,446	(25,178,446)	\$16,918,605	(16,918,605)
Other Financing Sources				
Imputed Financing (Note 12)	30,373		229,139	
Adjustments to Financing Sources (+/-)	(3,840,641)		(513,322)	
Total Financing Sources	\$21,368,178	\$(412,266)	\$16,634,422	\$1,487,066
Net Cost of Operations (+/-)	\$(22,031,152)		\$(18,430,626)	
Ending Balances (Note 10)	\$(4,573,804)	\$9,813,595	\$(3,910,829)	\$10,225,861

The accompanying notes are an integral part of these statements.



**United States Department of Education**  
**Federal Student Aid**  
**Combined Statement of Budgetary Resources**  
**For the Periods Ended September 30, 2003 and 2002**  
(Dollars in Thousands)

	Fiscal Year 2003		Fiscal Year 2002	
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts
<b>Budgetary Resources:</b>				
Budget Authority :				
Appropriations Received	\$25,353,248		\$18,426,874	
Borrowing Authority		\$21,726,323		\$21,995,839
Net Transfers	(14,699)			
Unobligated Balance:				
Beginning of Period	3,524,621	7,804,299	1,646,189	5,094,963
Beginning of Period Adjustments (Note 13)			2,462,445	
Spending Authority From Offsetting Collections:				
Earned				
Collected	5,303,723	32,954,804	2,527,286	22,612,536
Change in Unfilled Customer Orders				
Without advance from Federal sources	513			
Subtotal	\$5,304,236	\$32,954,804	\$2,527,286	\$22,612,536
Recoveries of Prior Year Obligations	864,370	268,890	441,210	7,867
Permanently Not Available	(5,706,555)	(17,401,499)	(2,501,494)	(8,296,136)
<b>Total Budgetary Resources (Note 13)</b>	<b>\$29,325,221</b>	<b>\$45,352,817</b>	<b>\$23,002,510</b>	<b>\$41,415,069</b>
<b>Status of Budgetary Resources:</b>				
Obligations Incurred: (Note 13)				
Direct	\$27,005,648	\$35,587,722	\$19,477,889	\$33,610,770
Reimbursable	513			
Subtotal	\$27,006,161	\$35,587,722	\$19,477,889	\$33,610,770
Unobligated Balance:				
Apportioned	47,684	395,950	2,045,230	1,119,600
Unobligated Balance Not Available	2,271,376	9,369,145	1,479,391	6,684,699
<b>Total Status of Budgetary Resources</b>	<b>\$29,325,221</b>	<b>\$45,352,817</b>	<b>\$23,002,510</b>	<b>\$41,415,069</b>
<b>Relationship of Obligations to Outlays:</b>				
Obligated Balance, Net, Beginning of Period	\$9,918,833	\$6,786,293	\$8,408,634	\$5,577,090
Obligated Balance, Net, End of Period:				
Unfilled customer orders from Federal Sources	(513)			
Undelivered Orders	9,546,177	8,373,221	8,885,651	6,776,923
Accounts Payable	786,526	16,338	1,033,183	9,370
Outlays:				
Disbursements	25,727,920	33,715,565	17,526,479	32,393,699
Collections	(5,303,723)	(32,954,804)	(2,527,286)	(22,612,536)
Subtotal	\$20,424,197	\$760,761	\$14,999,193	\$9,781,163
Less: Offsetting Receipts	43,572		39,041	
<b>Net Outlays (Note 13)</b>	<b>\$20,380,625</b>	<b>\$760,761</b>	<b>\$14,960,152</b>	<b>\$9,781,163</b>

The accompanying notes are an integral part of these statements.

**United States Department of Education  
Federal Student Aid  
Consolidated Statement of Financing  
For the Periods Ended September 30, 2003 and 2002**

(Dollars in Thousands)

	Fiscal Year 2003	Fiscal Year 2002
Resources Used to Finance Activities		
Budgetary Resources Obligated		
Obligations Incurred (Note 13)	\$(62,593,883)	\$(53,088,659)
Less: Spending Authority from Offsetting Collections & Recoveries	39,392,300	25,588,899
Obligations Net of Offsetting Collections and Recoveries	(23,201,583)	(27,499,760)
Less: Offsetting Receipts	(43,572)	(39,041)
Net Obligations	\$(23,245,155)	\$(27,538,801)
Other Resources		
Imputed Financing From Costs Absorbed by Others (Note 12)	(30,373)	(229,139)
Net Other Resources Used to Finance Activities	(30,373)	(229,139)
Total Resources Used to Finance Activities	\$(23,275,528)	\$(27,767,940)
Resources Used to Finance Items Not Part of Net Cost of Operations		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not Yet Provided (+/-)	\$(1,975,219)	\$(3,100,854)
Resources that Fund Expenses Recognized in Prior Period	(1,216,284)	\$(4,454)
Credit Program Collections Which Increase/Decrease Liabilities for Loan Guarantees, or Credit Program Receivables, Net including Allowances for Subsidy	31,744,588	21,202,251
Resources Used to Finance the Acquisition of Fixed Assets, or Increase/Decrease Liabilities for Loan Guarantees or Credit Program Receivables, Net in Current or Prior Period	(28,047,641)	(26,538,217)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	\$505,444	\$(8,441,274)
Total Resources Used to Finance the Net Cost of Operations	\$(23,780,972)	\$(19,326,666)
Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Periods		
Increase in Annual Leave Liability	\$(3,322)	\$(2,714)
Upward/Downward Reestimates of Credit Subsidy Expense	(1,317,771)	\$(1,796,889)
Increase in Exchange Revenue Receivable from the Public	1,087,940	\$1,127,116
Other (+/-)	40,642	36,959
Total Components of the Net Cost of Operations that Will Require or Generate Resources in Future Periods	\$(192,511)	\$(635,528)
Components Not Requiring or Generating Resources		
Depreciation and Amortization	\$1,942,426	\$1,529,264
Other (+/-)	(95)	2,304
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources	\$1,942,331	\$1,531,568
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	\$1,749,820	\$896,040
Net Cost of Operations	\$(22,031,152)	\$(18,430,626)

The accompanying notes are an integral part of these statements.

## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

### **Note 1. Summary of Significant Accounting Policies**

#### **Reporting Entity**

Federal Student Aid (FSA) was created as a Performance Based Organization (PBO) within the U.S. Department of Education (the Department) under the Higher Education Act of 1965 (HEA) amendments enacted in 1998, from previously existing Department student financial assistance programs. FSA operates under the PBO mandate to develop a management structure driven by strong incentives to manage for results. FSA's primary goal is to assist lower-income and middle-income students in overcoming the financial barriers that make it difficult to attend and complete postsecondary education. It is responsible for administering direct loans, guaranteed loans, and grant programs.

The Federal Direct Student Loan Program, authorized by the Student Loan Reform Act of 1993, makes loans directly to eligible undergraduate and graduate students and their parents through participating schools. FSA borrows money from Treasury to fund the loans. The program provides interest subsidies for eligible borrowers.

The Federal Family Education Loan (FFEL) Program, authorized by the HEA of 1965, as amended, cooperates with state and private non-profit Guaranty Agencies to provide loan guarantees and interest subsidies on loans made by private lenders to eligible students.

The Grant Programs, consisting of Pell Grant and Campus-Based Programs, provide educational grants and other financial assistance to eligible applicants, which are not repaid by students to the Federal Government. The Pell Grant Program provides grant aid to low-income and middle-income undergraduate students. Awards vary in proportion to the financial circumstances of students and their families. The Campus-Based Programs provide educational grants and other financial assistance to eligible applicants. These programs include the Supplemental Educational Opportunity Grant, Work-Study, and Perkins Loan. Campus-Based programs are not material to these statements and have been included with other programs reported under Grants.

#### **Basis of Accounting and Presentation**

These consolidated financial statements have been prepared to report the financial position, net cost of operations, changes in net position, budgetary resources, and financing of the Federal Student Aid reporting group, as required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. The financial statements were prepared from the books and records of FSA, in accordance with accounting principles generally accepted (GAAP) in the United States of America and Office of Management and Budget (OMB) Bulletin 01-09, "Form and Content of Agency Financial Statements." GAAP for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), which is the official standard setting body for the federal government. These financial statements are different from the financial reports prepared by the Department pursuant to OMB directives that are used to monitor and control FSA's use of budgetary resources.

The financial statements should be read with the realization they represent the reporting group, FSA, within the Department of Education. One implication of this is that liabilities cannot be liquidated without legislation providing resources and legal authority to do so.



## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

The accounting structure of Federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of Federal funds.

### **Use of Estimates**

The preparation of the financial statements in accordance with generally accepted accounting principles in the United States requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements. Actual results may differ from those estimates.

Estimates for credit program receivables and liabilities contain assumptions that have a significant impact on the financial statements. The primary components of this assumption set include, but are not limited to, collections (including loan consolidations), repayments, default rates, prevailing interest rates and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these assumption components may create significant changes to the estimate.

FSA and the Department recognize the sensitivity of the changes in assumptions and the impact that the projections can have on the estimate. Management has attempted to mitigate these fluctuations by using trend analysis to project future cash flows. The assumptions used for the September 30, 2003 and 2002 financial statements are based on the best information available at the time the estimate was derived.

Changes in assumptions could significantly affect the amounts reflected in these statements. For example, a long-term change in the projected interest rate charged to borrowers could change the current subsidy re-estimate by a significant amount.

The model and estimating methods used are updated periodically to reflect changing conditions. This model was the official estimating model of the Department as of September 30, 2003 and 2002, and was used to calculate the subsidy re-estimates recorded in these financial statements.

### **Budget Authority**

Budget authority is the authorization provided by law for the Department and FSA to incur financial obligations that will result in outlays. FSA's budgetary resources for fiscal years 2003 and 2002 included (1) unobligated balances of resources from prior years, (2) recoveries of obligations in prior years, and (3) new resources—appropriations, authority to borrow from the U.S Department of Treasury (Treasury), and spending authority from collections and certain collection-related activity. Unobligated balances associated with resources expiring at the end of the fiscal year remain available for five years after expiration only for net upward adjustments of prior-year obligations, after which they are canceled and may not be used. Unobligated balances of resources that have not expired at year-end may have new obligations placed against them, as well as net upward adjustments of prior-year obligations.

Treasury Debt provides most of the funding for the loan principal disbursements made under the Federal Direct

## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

Student Loan Program. Subsidy and administrative costs of the program are funded primarily by appropriations. Budgetary resources from collections are used primarily to repay the FSA's debt to Treasury. Major sources of collections include (1) principal and interest collections from borrowers or through the consolidation of loans to borrowers, (2) related fees, and (3) interest from Treasury on balances in certain credit accounts that make and administer loans and guarantees.

### **Fund Balance with Treasury**

FSA maintains cash accounts with Treasury. The fund balance with Treasury includes appropriated and revolving funds available to pay current liabilities and finance authorized purchases, as well as funds restricted until future appropriations are received. Treasury processes the cash receipts and cash disbursements for FSA. FSA's records are reconciled with those of Treasury. (See Note 2.)

### **Cash and Other Monetary Assets**

Cash and other monetary assets consist of guarantee agency reserves and deposits in transit. Guaranty agency reserves represent FSA's interest in the net assets of the FFEL program guaranty agencies. Guaranty agency reserves are classified as non-entity assets with the public (see Note 3) and are offset by a corresponding liability due to Treasury. Guaranty agency reserves include initial federal start-up funds (guaranty agency advances), receipts of federal reinsurance payments, insurance premiums, guaranty agency share of collections on defaulted loans, investment income and administrative cost allowances, and other assets purchased out of reserve funds.

Section 422A of the HEA of 1965, as amended, required FFEL Guaranty Agencies to establish a Federal Student Loan Reserve Fund (the "Federal Fund") and an Operating Fund by December 6, 1998. The Federal Fund and the non-liquid assets developed or purchased by a Guaranty Agency as a result, in whole or in part with Federal funds, are the property of the United States. However, such ownership by FSA is independent of the actual control of the assets.

FSA disburses funds to the Guaranty Agency through the Federal Fund to pay lender claims and default aversion fees of a Guaranty Agency. The Operating Fund is the property of the Guaranty Agency except for funds an agency borrows from the Federal Fund (under Section 422A of the HEA of 1965, as amended). The Operating Fund is used by the Guaranty Agency to fulfill its responsibilities. These responsibilities include repaying money borrowed from the Federal Fund, default aversion and collection activities.

### **Accounts Receivable**

Accounts receivable are amounts due to FSA from the public and other Federal agencies. Receivables from the public typically result from such items as overpayments of educational assistance, whereas amounts due from other Federal agencies result from agreements entered into by FSA with these agencies for various goods and services. Accounts receivable are recorded at cost less an allowance for uncollectible amounts.



## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

### Credit Program Receivables and Loan Guarantee Liabilities

The financial statements at September 30, 2003 and 2002, reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the Federal Credit Reform Act of 1990 (the Act). Loans and interest receivable are valued at their gross amounts less an allowance for the present value of the amounts not expected to be recovered and thus having to be subsidized—called "allowance for subsidy." The difference is the present value of the cash flows to and from FSA that are expected from the receivables over their expected lives. Similarly, loan guarantee liabilities are valued at the present value of the cash outflows from FSA less the present value of related inflows. GAAP allows direct loans and loan guarantees obligated prior to October 1, 1992, to be stated on a present value basis or on a net realizable or expected value basis. FSA has chosen to record all loans and guarantees at their present values.

Components of subsidy costs involved with loans and guarantees include defaults, net of recoveries, contractual payments to third-party private loan collectors who receive a set percentage of amounts they collect, and, as an offset, application and other fees to be collected. For direct loans, the difference between interest rates incurred by the Department and FSA on its borrowings from the Department of Treasury and interest rates charged to target groups is also subsidized (or may provide an offset to subsidy if the Department's rate is less). The corresponding interest subsidy in loan guarantee programs is the payment of interest supplements to third party lenders in order to buy down the interest rates on loans made by those lenders. Subsidy costs are recognized when direct loans or guaranteed loans are disbursed to borrowers and are re-estimated each year. (See Note 4.)

### General Property, Plant, and Equipment

In accordance with the Department policy, FSA capitalizes single items of property and equipment with an aggregate cost of \$50,000 or more that have an estimated useful life greater than two years. FSA also capitalizes bulk purchases of property and equipment with an aggregate cost of \$500,000 or more. A bulk purchase is defined as the purchase of like items related to a specific project or the purchase of like items occurring within the same fiscal year that have an estimated useful life greater than two years. Property and Equipment are depreciated over their estimated useful lives using the straight-line method of depreciation.

The Department adopted the following useful lives for the major classes of depreciable property and equipment:

Major Classes of Depreciable Property and Equipment	Years
Information Technology (IT) and Telecommunications equipment	3
Furniture and Fixtures	5

### Liabilities

Liabilities represent actual and estimated amounts likely to be paid as a result of transactions or events that have already occurred. However, no liabilities can be paid by FSA or the Department without an appropriation or other collection of revenue for services provided. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources and there is no certainty the appropriation will be enacted. Liabilities of FSA and the Department arising from other than contracts can be abrogated by the



## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

Government acting in its sovereign capacity. FFEL and Federal Direct Student Loan Program liabilities are entitlements covered by permanent indefinite budget authority enacted as of year-end.

### **Liabilities for Loan Guarantees**

The liability for loan guarantees under FFEL is the estimated present value of net long-term cash outflows of FSA for subsidized costs - primarily defaults, net of recoveries, interest supplements, and, as an offset, fees. (See Note 4.)

### **Treasury Debt**

The amount shown for the liability to Treasury from borrowings represents unpaid principal owing on the loans at year-end associated with FSA's student loan activities. FSA repays the loan principal based on available fund balances. Interest on the debt is calculated at fiscal year-end using rates set by Treasury with such rates generally fixed based on the rate for 10-year securities. As discussed in Note 4, the interest received by FSA from borrowers will vary from the rate paid to the Treasury. Principal and interest payments are made annually. (See Note 5.)

### **Accrued Grant Liability**

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. A liability is accrued by FSA for expenditures incurred by grantees prior to receiving grant funds for the expenditures. The amount is estimated using statistical sampling techniques. (See Note 9.)

### **Net Position**

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances of appropriations, except those for federal credit financing and liquidating funds. Cumulative results of operations represent the net difference since inception between (1) expenses and (2) revenues and financing sources. (See Note 10.)

### **Personnel Compensation and Other Employee Benefits**

#### **Annual, Sick and Other Leave**

The liability for annual leave, compensatory time off, and other leave is accrued when earned and reduced when taken. Each year, the accrued annual leave account balance is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

### Retirement Plans and Other Employee Benefits

Employees participate either in the Civil Service Retirement System (CSRS), a defined benefit plan, or in the Federal Employees Retirement System (FERS), a defined benefit and contribution plan. For CSRS employees, the Department contributes a fixed percentage of pay. For FERS employees, the Department contributes fixed percentages to both a defined benefits plan and a defined contributions plan (Thrift Savings Plan). For FERS employees, the Department also contributes the employer's share for Social Security (FICA) and Medicare.

The FERS program is fully funded by agency and worker contributions. Such contributions for other retirement plans and benefits are insufficient to fully fund the programs, which are subsidized by the Office of Personnel Management (OPM). The Department imputes its share of the OPM subsidy, using cost factors OPM provides, and reports the full cost of the programs related to its employees. (See Note 12.)

### Federal Employees Compensation Act

The Federal Employees Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (Labor), which pays valid claims and subsequently seeks reimbursement from the Department for these paid claims.

The FECA liability consists of two components. The first component is based on actual claims paid by Labor but not yet reimbursed by the Department. The Department reimburses Labor for the amount of actual claims as funds are appropriated for this purpose. There is generally a two to three year time period between payment by Labor and reimbursement to Labor by the Department. As a result, the Department recognizes a liability for the actual claims paid by Labor and to be reimbursed by the Department.

The second component is the estimated liability for future benefit payments as a result of past events. This liability includes death, disability, medical and miscellaneous costs. Labor determines this component annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. The projected annual benefit payments are discounted to present value using OMB economic assumptions for 10-year Treasury notes and bonds. To provide for the effects of inflation on the liability, wage inflation factors (i.e., cost of living adjustments) and medical inflation factors (i.e., consumer price index medical adjustments) are applied to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments and to adjust future benefit payments to current-year constant dollars. A discounting formula is also used to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

Labor evaluates the estimated projections to ensure that the resulting projections were reliable. The analysis includes two tests: (1) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments, and (2) a comparison of the ratio of the estimated liability to the actual payment of the beginning year calculated for the current projection to the liability-payment ratio calculated for the prior projection.

## **Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002**

A portion of the estimated liability for disability benefits assigned to the Department under the Federal Employees Compensation Act (FECA) is accrued by FSA. The accrual is based on the present value of estimated net future payments by the Department of Labor, which administers the FECA program.

### **Intragovernmental Transactions**

FSA's financial activities interact and are dependant upon the financial activity of the centralized management functions of the Federal government. FSA is subject to financial regulation and management control by OMB and Treasury. As a result of this relationship, operations may not be conducted and financial positions may not be reported as they would if FSA were a separate, unrelated entity.



# Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

## Note 2. Fund Balance with Treasury

Fund balance with Treasury consisted of the following at September 30, 2003 and 2002:

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Appropriated Funds	\$ 11,543,769	\$ 12,274,347
Revolving Funds	11,184,927	9,656,826
Other Funds	7,563	7,563
<b>Total Fund Balance with Treasury</b>	<b>\$ 22,736,259</b>	<b>\$21,938,736</b>

### Status of Fund Balance with Treasury

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Unobligated Balance		
- Available	\$ 443,634	\$ 3,164,830
- Unavailable	10,533,040	6,994,983
Obligated Balance, Not Yet Disbursed	11,752,022	11,771,360
Other Funds	7,563	7,563
<b>Total Status of Fund Balance with Treasury</b>	<b>\$ 22,736,259</b>	<b>\$ 21,938,736</b>

Fund Balance with Treasury is an entity asset maintained with Treasury. The monies are available to pay current liabilities and finance loan programs. The Department has the authority to disburse the funds directly to agencies and institutions participating in its programs through the Treasury, which processes cash receipts and disbursements on its behalf.

Revolving funds conduct continuing cycles of business-like activity and do not require an annual appropriation. Their fund balance comes from collections from other Federal entities, the public, and from borrowings.

Available unobligated balances represent amounts that are apportioned for obligation in the current fiscal year. Unavailable unobligated balances represent amounts that are not apportioned for obligation during the current fiscal year and expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include reimbursements and other income earned, undelivered orders and expended authority-unpaid. Other funds primarily consist of suspense, deposit funds and clearing accounts.

Notes to Principal Financial Statements  
For the Years Ended September 30, 2003 and 2002

**Note 3. Cash and Other Monetary Assets**

Cash and other monetary assets consisted of the following at September 30, 2003 and 2002:

<u>(Dollars in Thousands)</u>	<b>2003</b>		
	<u>Guaranty Agency Reserves</u>	<u>Deposits in Transit</u>	<u>Total</u>
<b>Beginning Balance, September 30</b>	\$ 1,169,107	\$ 35,420	\$ 1,204,527
Current Year Activity	(61,626)	(35,416)	(97,042)
<b>Ending Balance, September 30</b>	<u>\$ 1,107,481</u>	<u>\$ 4</u>	<u>\$ 1,107,485</u>

<u>(Dollars in Thousands)</u>	<b>2002</b>		
	<u>Guaranty Agency Reserves</u>	<u>Deposits in Transit</u>	<u>Total</u>
<b>Beginning Balance, September 30</b>	\$ 2,462,445	\$ -	\$ 2,462,445
Current Year Activity	(208,606)	35,420	(173,186)
Funds Recall	(1,084,732)	-	(1,084,732)
<b>Ending Balance, September 30</b>	<u>\$ 1,169,107</u>	<u>\$ 35,420</u>	<u>\$ 1,204,527</u>

Cash and Other Monetary Assets consist of Guaranty Agency reserves and deposits in transit. Guaranty Agency reserves are non-entity assets that the Guaranty Agencies collect and hold on behalf of the U.S. government. Additionally, Guaranty Agency reserves are a liability due to Treasury and are considered intragovernmental liabilities. These balances represent the Federal government's interest in the net assets of state and non-profit FFEL Program Guaranty Agencies. (See Note 1.)

In FY 2002, Guaranty Agencies participating in the FFEL program returned to Treasury, through the Department, \$1,085 million in Federal assets. On September 30, 2003, Guaranty Agencies held approximately \$1,107 million in Federal assets. The agencies use the funds to pay lender claims, primarily for loan defaults and discharges; the funds are replenished by FSA insurance payments to Guaranty Agencies. Consistent with Section 422A(e) of the HEA of 1965, these funds are considered "property of the United States" and are reflected in the president's budget.

## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

### **Note 4. Credit Program Receivables and Liabilities for Loan Guarantees**

The Department operates the William D. Ford Direct Student Loan and Federal Family Education Loan (FFEL) programs to help students finance the costs of higher education. Under the programs, the Department makes loans directly or guarantees all or a portion of loans made by participating lending institutions to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education—public and private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents receive loans regardless of income; student borrowers who demonstrate financial need also receive Federal interest subsidies.

Under the Direct Loan program, the Federal Government makes loans directly to students and parents through participating schools. Loans are originated and serviced through contracts with private vendors. Under the FFEL program, more than 4,000 financial institutions make loans directly to students and parents. FFEL loans are guaranteed by the Federal Government against default, with 36 state or private non-profit Guaranty Agencies acting as intermediaries in administering the guarantees. Beginning with loans first disbursed on or after October 1, 1993, financial institutions became responsible for 2 percent of the cost of each default; Guaranty Agencies also began paying a portion of the cost (in most cases, 5 percent) of each defaulted loan from Federal funds they hold in trust. FFEL lender participants receive statutorily set Federal interest and special allowance subsidies; Guaranty Agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The Federal Credit Reform Act of 1990 (the Act) underlies the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees, other than for general administration of the programs, is referred to as “subsidy cost.” Under the Act, subsidy costs for loans obligated beginning in FY 1992 are the net present value of projected lifetime costs in the year the loan is disbursed. Subsidy costs are revalued annually through the re-estimate process.

The Department estimates all future cash flows associated with Direct Loans and FFEL. Projected cash flows are used to develop subsidy estimates. Subsidy costs can be positive or negative; negative subsidies occur when expected program inflows of cash (e.g., repayments and fees) exceed expected outflows. Subsidy is recorded as the initial amount of the loan guarantee liability when guarantees are made—the loan liability—and as a valuation allowance to government held loans and interest receivable (i.e., direct and defaulted guaranteed loans).

The Department uses a computerized cash flow projection model to calculate subsidy estimates for direct loans and guaranteed FFEL program loans. Cash flows are projected over the life of the loan, aggregated by loan type, cohort year, and risk category. The loan’s cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary (for-profit) schools.

The estimates reflected in these statements were prepared using assumptions developed for the FY 2004 Mid-Session Review, a government-wide exercise required annually by the OMB. These estimates are the most current available to the Department at the time the financial statements are prepared. Department management has a process to review these estimates in the context of subsequent changes in assumptions, and reflect the impact of



## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

these changes as appropriate.

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. Under the Act and requirements provided by OMB Circular A-11 (Budget Formulation and Execution), the retirement of loans being consolidated is considered a receipt of principal and interest; this receipt is offset by the disbursement related to the newly created consolidation loan. The underlying direct or guaranteed loans, whether performing or non-performing, in any given cohort are paid off in their original cohort and new loans are opened in the cohort in which consolidation activity occurs. This consolidation activity is taken into consideration in setting the subsidy rate for defaults.

The FFEL estimated liability for loan guarantees is reported as the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and cancellations. The same methodology is used to estimate the allowance on Direct Loans receivables.

The Department disbursed approximately \$18 billion in Direct Loans to eligible borrowers in FY 2003 and approximately \$20 billion in loans in FY 2002. Half of all loan volume is obligated in the fourth quarter of the fiscal year. Loans typically disburse in multiple installments over an academic period; as a result, loan disbursements for an origination cohort year often cross fiscal years. Regardless of the fiscal year in which they occur, disbursements are tracked by the cohort to which they belong, which is determined by the time of obligation rather than disbursement.

As of September 30, 2003 and 2002, the total principal balance outstanding of guaranteed loans held by lenders were approximately \$213 billion and \$182 billion, respectively. As of September 30, 2003 and 2002, the estimated maximum government exposure on outstanding guaranteed loans held by lenders was approximately \$209 billion and \$179 billion, respectively. Of the insured amount, the Department would pay a smaller amount to the Guaranty Agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the Guaranty Agencies from their Federal funds. Payments by Guaranty Agencies do not reduce government exposure because they are made from Federal funds administered by the agencies.

The Department accrues interest receivable and records interest revenue on its performing direct loans. Given the Department's substantial collection rates, interest receivable is also accrued and interest revenue recognized on defaulted direct loans. Guaranteed loans that default are initially turned over to Guaranty Agencies for collection and interest receivable is accrued and recorded on the loans as the collection rate is substantial. After approximately four years, defaulted guaranteed loans not in repayment are turned over to the Department for collection. Due to the age of these loans, accrued interest is calculated but only recorded upon collection. Interest income is not recognized on defaulted guaranteed loans and collections of interest are considered recoveries of prior cost.

As previously noted, borrowers may pre-pay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan. The loan liability and net receivables include estimates of future prepayments of existing loans; they do not reflect costs associated with anticipated future consolidation loans.

**Notes to Principal Financial Statements**  
**For the Years Ended September 30, 2003 and 2002**

Due to the nature of the loan commitment process in which schools establish a loan commitment with the filing of an aid application, which may occur before a student has been accepted by the school or begins classes, approximately 7 percent of loan commitments are never disbursed. For Direct Loans committed in FY 2003, an estimated \$1.2 billion will not be disbursed; for guaranteed loans committed in FY 2003, an estimated \$4.9 billion will not be disbursed.

**Notes to Principal Financial Statements  
For the Years Ended September 30, 2003 and 2002**

**Credit Program Receivables, Net**

The Credit Program Receivables, Net consist of the following program loans:

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Direct Loan Program Loan Receivables, Net	\$ 86,633,897	\$ 84,846,534
FFEL Program Loan Receivables, Net	10,785,912	6,287,762
Perkins Program Loan Receivables, Net	194,848	192,371
<b>Credit Program Receivables, Net</b>	<b><u>\$ 97,614,657</u></b>	<b><u>\$ 91,326,667</u></b>

The following schedules summarize the direct and defaulted FFEL loan principal and related interest receivable, net or inclusive of the allowance for subsidy. (See Note 1.)

<u>Direct Loan Program Receivables</u>		
<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Principal Receivable	\$ 84,520,521	\$ 80,070,351
Interest Receivable	2,770,780	2,661,242
<b>Receivables</b>	<b>87,291,301</b>	<b>82,731,593</b>
Allowance for Subsidy	(657,404)	2,114,941
<b>Credit Program Receivables, Net</b>	<b><u>\$ 86,633,897</u></b>	<b><u>\$ 84,846,534</u></b>

Of the \$87.3 billion in Direct Loan receivables as of September 30, 2003, \$5.6 billion are currently in default and held at the Department's Borrowers Services Collections Group. As of September 2002, \$4.3 billion were in default and held at the Department's Borrowers Services Collections Group out of a total receivable of \$82.7 billion.

<u>FFEL Program Credit Program Receivables</u>						
<u>(Dollars in Thousands)</u>	<u>2003</u>			<u>2002</u>		
	<u>Pre-1992</u>	<u>Post-1991</u>	<u>Total</u>	<u>Pre-1992</u>	<u>Post-1991</u>	<u>Total</u>
Principal Receivable	\$ 10,555,230	\$ 7,119,031	\$ 17,674,261	\$ 11,656,526	\$ 6,098,623	\$ 17,755,149
Interest Receivable	1,143,591	1,553,490	2,697,081	1,284,433	1,732,193	3,016,626
<b>Receivables</b>	<b>11,698,821</b>	<b>8,672,521</b>	<b>20,371,342</b>	<b>12,940,959</b>	<b>7,830,816</b>	<b>20,771,775</b>
Allowance for Subsidy	(8,273,252)	(1,312,178)	(9,585,430)	(11,904,071)	(2,579,942)	(14,484,013)
<b>Credit Program Receivables, Net</b>	<b><u>\$ 3,425,569</u></b>	<b><u>\$ 7,360,343</u></b>	<b><u>\$ 10,785,912</u></b>	<b><u>\$ 1,036,888</u></b>	<b><u>\$ 5,250,874</u></b>	<b><u>\$ 6,287,762</u></b>



**Notes to Principal Financial Statements  
For the Years Ended September 30, 2003 and 2002**

**Direct Loan Program Reconciliation of Allowance for Subsidy**

The reconciliation of allowance for subsidy for the Direct Loan Program follows:

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
<b>Beginning Balance, Allowance for Subsidy</b>	<b>\$ 2,114,941</b>	<b>\$ 1,568,317</b>
<b>Components of Subsidy Transfers</b>		
Interest Rate Differential	1,724,006	1,500,008
Defaults, Net of Recoveries	(612,976)	(210,714)
Fees	377,366	302,128
Other	(1,122,001)	(869,493)
<b>Current Year Subsidy Transfers from Program Account</b>	<b>366,395</b>	<b>721,929</b>
<b>Components of Subsidy Re-estimates</b>		
Interest Rate Re-estimates <sup>1</sup>	(388,772)	-
Technical and Default Re-estimates	(4,693,652)	(1,598,930)
<b>Total Subsidy Re-estimates</b>	<b>(5,082,424)</b>	<b>(1,598,930)</b>
<b>Activity</b>		
Fee Collections	(408,367)	(374,592)
Loan Cancellations <sup>2</sup>	103,640	39,420
Subsidy Allowance Amortization	1,953,233	1,537,294
Other	295,178	221,503
<b>Total Activity</b>	<b>1,943,684</b>	<b>1,423,625</b>
<b>Ending Balance, Allowance for Subsidy</b>	<b>\$ (657,404)</b>	<b>\$ 2,114,941</b>

<sup>1</sup> The interest rate re-estimate relates to subsidy associated with establishing a fixed rate for the Department's borrowing from Treasury. This re-estimate is recorded as a separate component in 2003.

<sup>2</sup> Loan cancellations include write-offs of loans because the primary borrower died, became disabled, or declared bankruptcy.

**Notes to Principal Financial Statements  
For the Years Ended September 30, 2003 and 2002**

**FFEL Program Reconciliation of Liabilities for Loan Guarantees**

Liabilities for loan guarantees represent the present value of future projected cash outflows from the Department, net of inflows, such as fees, and collection of principal and interest on defaulted guaranteed loans assumed for direct collection. (See Note 1.)

The FFEL Program liability for loan guarantees reconciliation is associated with the FFEL Program loans guaranteed in the financing account. The FFEL liquidating account Liability for Loan Guarantees is included in the total Liabilities for Loan Guarantees.

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
<b>Beginning Balance, Liability for Loan Guarantees</b>	<b>\$ 11,570,498</b>	<b>\$ 8,226,207</b>
<b>Components of Subsidy Transfers</b>		
Interest Supplement Costs	5,569,423	3,455,302
Defaults, Net of Recoveries	1,398,038	1,115,428
Fees	(3,181,346)	(2,118,056)
Other <sup>1</sup>	2,086,899	1,337,713
<b>Current Year Subsidy Transfers from Program Account</b>	<b>5,873,014</b>	<b>3,790,387</b>
<b>Components of Subsidy Re-estimates</b>		
Interest Rate Re-estimates	3,887	-
Technical and Default Re-estimates	(2,533,956)	128,444
<b>Subsidy Re-estimates in Liability</b>	<b>(2,530,069)</b>	<b>128,444</b>
<b>Activity</b>		
Interest Supplement Payments	(2,087,503)	(2,327,175)
Claim Payments	(2,833,905)	(2,779,963)
Fee Collections	2,024,828	1,515,435
Interest on Liability Balance	457,669	415,719
Other <sup>2</sup>	2,835,481	2,601,444
<b>Total Activity</b>	<b>396,570</b>	<b>(574,540)</b>
<b>Ending Balance, Liability for Loan Guarantees</b>	<b>15,310,013</b>	<b>11,570,498</b>
FFEL Liquidating Account Liability for Loan Guarantees	121,702	108,895
<b>Total Liabilities for Loan Guarantees</b>	<b>\$ 15,431,715</b>	<b>\$ 11,679,393</b>

<sup>1</sup> Subsidy primarily associated with debt collections, loan cancellations due to death, disability, and bankruptcy.

<sup>2</sup> Activity primarily associated with the transfer of subsidy for defaults; loan consolidation activity; and loan cancellations due to death, disability, and bankruptcy.

# Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

## Subsidy Expense

Direct Loan Program and FFEL Program subsidy expenses are as follows:

<b>Direct Loan Program Subsidy Expense</b>		
<b>(Dollars in Thousands)</b>	<b>2003</b>	<b>2002</b>
<b>Components of Current-Year Subsidy Transfers</b>		
Interest Rate Differential	\$ (1,724,006)	\$ (1,500,008)
Defaults, Net of Recoveries	612,976	210,714
Fees	(377,366)	(302,128)
Other	1,122,001	869,493
<b>Current Year Subsidy Transfers</b>	<b>(366,395)</b>	<b>(721,929)</b>
Re-estimates	5,082,424	1,598,930
<b>Direct Loan Subsidy Expense</b>	<b>\$ 4,716,029</b>	<b>\$ 877,001</b>

The \$5.1 billion upward re-estimate of existing loans in 2003 is composed of a \$4.2 billion re-estimate for 2003, of which \$0.5 billion relates to loans originated in 2003, and an additional re-estimate for 2002 of \$0.9 billion resulting from the 2004 President's Budget (January 2003).

<b>FFEL Program Loan Guarantee Subsidy Expense</b>		
<b>(Dollars in Thousands)</b>	<b>2003</b>	<b>2002</b>
<b>Components of Current-Year Subsidy Transfers</b>		
Interest Supplement Costs	\$ 5,569,423	\$ 3,455,302
Defaults, Net of Recoveries	1,398,038	1,115,428
Fees	(3,181,346)	(2,118,056)
Other	2,086,899	1,337,713
<b>Current Year Subsidy Transfers</b>	<b>5,873,014</b>	<b>3,790,387</b>
Re-estimates	(3,364,747)	197,959
<b>FFEL Loan Guarantee Subsidy Expense</b>	<b>\$ 2,508,267</b>	<b>\$ 3,988,346</b>

The \$3.4 billion downward re-estimate of existing loans in 2003 is composed of a \$2.9 billion re-estimate for 2003, of which \$1.1 billion relates to loans originated in 2003, and an additional re-estimate for 2002 of \$0.5 billion resulting from the 2004 President's Budget (January 2003).



# Notes to Principal Financial Statements

## For the Years Ended September 30, 2003 and 2002

### Subsidy Rates

The subsidy rates applicable to the 2003 loan cohort year are as follows:

Subsidy Rates - Cohort 2003					
	Interest Differential	Defaults	Fees	Other	Total
Direct Loan Program	(9.01%)	3.14%	(1.99%)	6.40%	(1.46%)
	Interest Supplements	Defaults	Fees	Other	Total
FFEL Program	9.12%	2.21%	(5.22%)	3.47%	9.58%

The subsidy rates disclosed pertain only to the cohort listed. These rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the Department or third-party lenders disburse guaranteed loans. The 2003 re-estimates for the Direct Loan and FFEL programs included re-estimates for the 2003 cohort; the result of these re-estimates effectively changed the executed subsidy rates shown in the chart above. The effective Direct Loan subsidy rate for the 2003 cohort is 1.14 percent – (0.98) percent interest differential, (0.03) percent defaults, (2.16) percent fees and 4.32 percent other. In the FFEL program, the effective subsidy rate for the 2003 cohort is 7.79 percent – 7.39 percent interest supplements, 1.68 percent defaults, (3.89) percent fees and 2.61 percent other.

### Administrative Expenses

The administrative expenses for Direct Loan and FFEL are as follows:

(Dollars in Thousands)	2003		2002	
	Direct Loan	FFEL	Direct Loan	FFEL
Operating Expense	\$ 358,285	\$ 270,553	\$ 393,848	\$ 462,655
Other Interest Expense	92	2	152	14
Benefit Expense	(184)	(99)	184	99
Depreciation, Amortization Expense	10,745	63	7,995	34
Future Funded Expenses	(789)	1,136	121	(149)
Changes in Actuarial Liability	(1)	1,094	303	(244)
<b>Total Administrative Expenses</b>	<b>\$ 368,148</b>	<b>\$ 272,749</b>	<b>\$ 402,603</b>	<b>\$ 462,409</b>

# Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

## Perkins Loan Program

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In FY 2003, FSA provided funding of 85.2 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. In FY 2002, FSA provided 85.5 percent. For certain defaulted loans, FSA reimburses the originating school and collects from the borrowers. At September 30, 2003 and 2002, loans receivable, net of an allowance for loss, was \$195 million and \$192 million, respectively. These loans, originally disbursed as grants, are valued at historical cost.

## Note 5. Treasury Debt

At September 30, 2003 and 2002, the FSA's Debt to the U.S. Treasury was \$91,787 million and \$89,498 million. The table below depicts the change in debt from October 1 to September 30:

<u>(Dollars in Thousands)</u>	<u>Direct Student Loans</u>	
	<u>2003</u>	<u>2002</u>
Beginning Balance	\$ 89,497,870	\$ 77,189,105
New Borrowing	19,636,641	20,604,901
Repayments	<u>(17,347,780)</u>	<u>(8,296,136)</u>
<b>Ending Balance</b>	<b><u>\$ 91,786,731</u></b>	<b><u>\$ 89,497,870</u></b>

Funds were borrowed to provide funding for direct loans to students.

The level of repayments on borrowings to Treasury is derived from many factors:

- Beginning-of-the-year cash balance, collections, borrowings, interest revenue, disbursements, and interest expense have an impact on the available cash to repay Treasury.
- Cash is held to cover future liabilities, such as contract collection costs and disbursements in transit.

# Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

## Note 6. Payable to Treasury

At September 30, 2003 and 2002, FSA reported \$7,023 million and \$4,713 million, respectively, as payable to the U.S. Treasury for estimated liquidating fund future cash inflows in excess of outflows and for downward re-estimates of subsidy, as shown in the table below.

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Future Liquidating Account Collections, Beginning Balance	\$ 2,007,080	1,506,429
Valuation of Pre-92 Loan Liability and Allowance	3,541,736	1,174,282
Capital Transfers to Treasury	(1,787,951)	(673,631)
Future Liquidating Account Collections, Ending Balance	3,760,865	2,007,080
FFEL Downward Subsidy Re-estimate	3,262,130	2,706,126
<b>Total Payable to Treasury</b>	<b>\$ 7,022,995</b>	<b>\$ 4,713,206</b>

In accordance with the Credit Reform Act, the liquidating fund pays monies to Treasury each year based on available fund balances, and the financing funds pay the liability related to downward subsidy re-estimates.

## Note 7. Other Liabilities

Other liabilities include current liabilities for contractual services, administrative services, deferred credit, liability for deposit funds, contingent liabilities, custodial liabilities and the liability for unfunded accrued annual leave. Additionally, the non-current liabilities include unfunded accrued FECA. Other liabilities as of September 30, 2003 and 2002 are as follows:

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
<b>Intragovernmental</b>		
Accrued Unfunded FECA Liability	\$ 772	\$ 704
Other Liabilities	-	3,835
<b>Total Intragovernmental</b>	<b>772</b>	<b>4,539</b>
<b>With the Public</b>		
Accrued Payroll and Benefits	2,802	4,928
Accrued Unfunded Annual Leave	6,874	6,878
Custodial Liability	194,848	188,665
Deferred Credits	6,982	-
Liability for Deposit Funds	7,563	7,563
Other Liabilities	100,459	114,853
<b>Total With the Public</b>	<b>319,528</b>	<b>322,887</b>
<b>Total Other Liabilities</b>	<b>\$ 320,300</b>	<b>\$ 327,426</b>



**Notes to Principal Financial Statements  
For the Years Ended September 30, 2003 and 2002**

**Note 8. Liabilities Not Covered by Budgetary Resources**

Liabilities on FSA's Balance Sheet as of September 30, 2003 and 2002, include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely and anticipated, it is not certain that appropriations will be enacted to fund these liabilities. Liabilities not covered by budgetary resources as of September 30, 2003 and 2002 are as follows:

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
<b>Intragovernmental</b>		
Accrued Unfunded FECA Liability	\$ 772	\$ 704
Other Liabilities	-	3,835
<b>Total Intragovernmental</b>	<u>772</u>	<u>4,539</u>
<b>With the Public</b>		
Custodial Liability	194,848	188,665
Accrued Unfunded Annual Leave	6,874	6,878
Federal Employee and Veterans' Benefits	5,369	4,277
<b>Total With the Public</b>	<u>207,091</u>	<u>199,820</u>
<b>Total Liabilities Not Covered by Budgetary Resources</b>	<b>207,863</b>	<b>204,359</b>
<b>Total Liabilities Covered by Budgetary Resources</b>	<u>116,220,105</u>	<u>108,185,872</u>
<b>Total Liabilities</b>	<u><b>\$ 116,427,968</b></u>	<u><b>\$ 108,390,231</b></u>

**Note 9. Accrued Grant Liability**

FSA's accrued grant liability was \$551 million as of September 30, 2003 and \$749 million as of September 30, 2002. (See Note 1.)

# Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

## Note 10. Net Position

The nature of FSA's net position was discussed in Note 1, and the components are set forth in the statement of changes in net position. The table below reports the composition of appropriations which have not been used to fund goods and services received or benefits provided as of September 30, 2003 and 2002.

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Unobligated		
Available	\$ 45,222	\$ 1,031,695
Not Available	279,215	291,437
Undelivered Orders	9,489,158	8,902,729
<b>Total Unexpended Appropriations</b>	<b>\$ 9,813,595</b>	<b>\$ 10,225,861</b>

Undelivered orders and unobligated balances for federal credit financing and liquidating funds are not included in the chart above because they are not funded through appropriations. As a result, unobligated and undelivered order balances in the chart above will differ from these balances in the Combined Statement of Budgetary Resources.

FSA had Cumulative Results of Operations of (\$4,574) million as of September 30, 2003, and (\$3,911) million as of September 30, 2002. Cumulative results of operations arise from unfunded expenses, capital equipment purchases, and upward loan subsidy re-estimates. Upward re-estimate expense contributing to the balance of Cumulative Results of Operations for the Direct Loan Program was \$5,083 million and \$1,599 million in fiscal years 2003 and 2002, respectively. (See Note 4.) The FFEL Program expensed \$3,365 million and \$198 million in fiscal years 2003 and 2002, respectively. (See Note 4.)

# Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

## Note 11. Interest Revenue and Expense

For the Direct Loan program, non-Federal interest revenue is earned on the individual non-defaulted loans in the loan portfolio and amortization of subsidy cost while Federal interest is earned on the uninvested fund balances with Treasury. For the Direct Loan program, interest expense is incurred on the Department's borrowings from Treasury. For the FFEL program, Federal interest revenue is earned on the uninvested fund balance with Treasury in the financing fund.

The interest revenues and expenses directly attributable to the Direct Loan Program and the FFEL Program are summarized below:

(Dollars in Thousands)	Direct Student Loans		FFEL Program		Total	
	2003	2002	2003	2002	2003	2002
<b>Interest Revenue:</b>						
Federal	\$ 1,076,148	\$ 972,063	\$457,669	\$415,719	\$1,533,817	\$ 1,387,782
Non-Federal	4,954,180	4,743,677	-	-	4,954,180	4,743,677
<b>Total Interest Revenue</b>	<b>\$ 6,030,328</b>	<b>\$5,715,740</b>	<b>\$457,669</b>	<b>\$415,719</b>	<b>\$6,487,997</b>	<b>\$ 6,131,459</b>
<b>Interest Expense:</b>						
Federal	\$ 6,030,328	\$5,715,740	\$457,669	\$415,719	\$6,487,997	\$ 6,131,459
Non-Federal	92	(20)	2	15	94	(5)
<b>Total Interest Expense</b>	<b>\$ 6,030,420</b>	<b>\$5,715,720</b>	<b>\$457,671</b>	<b>\$415,734</b>	<b>\$6,488,091</b>	<b>\$ 6,131,454</b>

## Note 12. Imputed Financing

The Statement of Changes in Net Position recognized an imputed financing source of \$30 million for the year ended September 30, 2003, and \$229 million for the year ended September 30, 2002. Corresponding imputed post-employment benefit expenses are recognized on the Statement of Net Cost as a program cost under salaries and administrative expense for both fiscal years. (See Note 1.) In addition, the cost allocation from Department Management is included as part of the imputed financing in support of FSA programs.



## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

### Note 13. Statement of Budgetary Resources

The Statement of Budgetary Resources compares budgetary resources with the status of those resources. As of September 30, 2003, budgetary resources were \$74,678 million and net outlays for the year were \$21,141 million. As of September 30, 2002, budgetary resources were \$64,418 million and net outlays for the year were \$24,741 million.

### Apportionment Categories of Obligations Incurred

FSA receives apportionments of its resources from OMB. Category A apportionments are those for resources that can be obligated without restriction on the purpose of the obligation, other than to be in compliance with legislation underlying programs for which the resources were made available. Category B apportionments are restricted by purpose for which obligations can be incurred. In addition, some resources are available without apportionment by OMB.

The apportionment categories of obligations incurred during FY 2003 and FY 2002 are summarized below:

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Direct:		
Category A	\$ 684,656	\$ 672,479
Category B	61,847,089	52,207,573
Exempt from Apportionment	<u>62,138</u>	<u>208,607</u>
<b>Total Apportionment Categories of Obligations Incurred</b>	<u><b>\$ 62,593,883</b></u>	<u><b>\$ 53,088,659</b></u>

### Adjustments to Beginning Balance of Budgetary Resources

Guaranty Agency reserves are non-entity assets that the Department collects and holds on behalf of the U.S. Government. These balances represent the federal government's interest in net assets of state and non-profit FFEL Program Guaranty Agencies (see Note 1). In FY 2002, the Department reclassified Guaranty Agency reserves from a receivable to "Cash and Other Monetary Assets" (see Note 3). This reclassification, for amounts prior to October 1, 2001, is reflected on the Statement of Budgetary Resources as an upward adjustment of \$2.5 billion to the beginning unobligated balance.

### Permanent Indefinite Appropriation

The Federal Direct Student Loan Program and the FFEL Program were granted permanent indefinite appropriation budget authority through legislation. Part D of the William D. Ford Federal Direct Loan Program and part B of the Federal Family Education Loan program, pursuant to the HEA of 1965, pertains to the existence, purpose, and availability of this permanent indefinite appropriations authority.

## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

### Unused Borrowing

FSA is given authority to draw funds from the U.S. Treasury to help finance the majority of its direct lending activity in accordance with its needs. Unliquidated Borrowing Authority is considered a budgetary resource and is available to support obligations at the end of the fiscal year. FSA periodically reviews its borrowing authority balances and cancels unused amounts. Unused Borrowing Authority as of September 30, 2003, and September 30, 2002, was determined as follows:

<u>(Dollars in Thousands)</u>	<u>2003</u>	<u>2002</u>
Beginning Balance, Unused Borrowing Authority	\$ 4,933,764	\$ 3,542,826
Current Year Borrowing Authority	21,726,323	21,995,839
Reductions to Borrowing Authority	(53,719)	-
Funds Drawn From Treasury	<u>(19,636,640)</u>	<u>(20,604,901)</u>
<b>Ending Balance, Unused Borrowing Authority</b>	<b><u>\$ 6,969,728</u></b>	<b><u>\$ 4,933,764</u></b>

### Comparison to the Budget of the United States Government

Statement of Federal Financial Accounting Standards No. 7 (*SFFAS No. 7*), *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires an explanation of material differences between budgetary resources available, the status of those resources and outlays as presented in the statement of budgetary resources to the related actual balances published in the *Budget of the United States Government*. However, the *Budget of the United States Government* has not yet been published. The Budget is scheduled for publication in February 2004 and will be available through OMB. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements. There were no material differences between the FY 2002 column on the Statement of Budgetary Resources and the FY 2002 actual amounts reported in the Budget of the United States Government.

## Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002

### **Note 14. Statement of Financing**

The Statement of Financing provides information on the total resources used by an agency, both those received through budgetary resources and those received through other means during the reporting period. The statement reconciles these resources with the net cost of operations by (1) removing resources which do not fund net cost of operations and (2) including components of net cost of operations that did not generate or use resources during the year.

The Statement of Financing is presented as a consolidated statement for the FSA and its major programs. Net interagency eliminations are presented for proprietary amounts. The budgetary amounts are reported on a combined basis as presented in the SBR. Accordingly, net interagency eliminations for budget amounts are not presented.

The relationship between the amounts reported as liabilities not covered by budgetary resources on the balance sheet and amounts reported as components requiring or generating resources in future periods on the statement of financing were analyzed. The differences are primarily due to the increase in custodial liability, which does not generate net cost of operations or require the use of budgetary resources.

### **Note 15. Contingencies**

#### **Guaranty Agencies**

FSA can assist Guaranty Agencies experiencing financial difficulties by advancing funds or by other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of Guaranty Agencies because the likelihood of such occurrences is uncertain and cannot be estimated with sufficient reliability.

#### **Perkins Loans Reserve Funds**

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In FY 2003, FSA provided funding of 85.2 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The school provided the remaining 14.8 percent of program funding. For the latest academic year ended June 30, 2003, approximately 763,890 loans were made, totaling \$1.5 billion at 1,742 institutions, averaging \$1,919 per loan. FSA's share of the Perkins Loan Program was approximately \$6.5 billion as of June 30, 2003.

In FY 2002, FSA provided funding of 85.5 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The school provided the remaining 14.5 percent of program funding. For the academic year ended June 30, 2002, approximately 663,527 loans were made, totaling \$1.2 billion at 1,790 institutions, averaging \$1,872 per loan. FSA's share of the Perkins Loan Program was approximately \$6.5 billion as of June 30, 2002.



## **Notes to Principal Financial Statements For the Years Ended September 30, 2003 and 2002**

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low-income areas, as a Peace Corps or VISTA volunteer, in the military or in law enforcement, nursing, or family services—may receive partial loan forgiveness for each year of qualifying service. In these circumstances a contingency is deemed to exist. FSA may be required to compensate Perkins Loan institutions for the cost of the partial loan forgiveness.

### **Litigation and Other Claims**

FSA is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against FSA are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on FSA's financial statements.

### **Other Matters**

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures which were subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on FSA or the Department's financial statements.



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*We Help Put America Through School*

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## Supplemental Financial Information

**United States Department of Education  
Federal Student Aid  
Consolidating Balance Sheet  
For the Period Ended September 30, 2003**

(Dollars in Thousands)

	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
<b>Assets:</b>				
Intragovernmental:				
Fund Balance with Treasury (Note 2)	\$22,736,259	\$12,687,053	\$1,273,160	\$8,776,046
Total Intragovernmental	22,736,259	12,687,053	1,273,160	8,776,046
Cash and Other Monetary Assets (Note 3)	1,107,485	1,107,485		
Accounts Receivable, Net	153,685	139,584	11,893	2,208
Credit Program Receivables, Net (Note 4)	97,614,657	10,785,912	86,633,897	194,848
General Property, Plant and Equipment, Net	16,857	92	16,765	
Other Assets	38,816	38,816		
<b>Total Assets</b>	<b>\$121,667,759</b>	<b>\$24,758,942</b>	<b>\$87,935,715</b>	<b>\$8,973,102</b>
<b>Liabilities:</b>				
Intragovernmental:				
Accounts Payable	\$3,924	\$545	\$3,379	
Treasury Debt (Note 5)	91,786,731		91,786,731	
Guaranty Agency Federal and Restricted Funds Due to Treasury (Note 3)	1,107,481	1,107,481		
Payable to Treasury (Note 6)	7,022,995	7,022,995		
Other Intragovernmental Liabilities (Note 7)	772	373	399	
<b>Total Intragovernmental</b>	<b>99,921,903</b>	<b>8,131,394</b>	<b>91,790,509</b>	
Accounts Payable	198,714	11,506	77,989	\$109,219
Accrued Grant Liability (Note 9)	550,739			550,739
Liabilities for Loan Guarantees (Note 4)	15,431,715	15,431,715		
Federal Employee and Veterans' Benefits	5,369	2,595	2,774	
Other Liabilities (Note 7)	319,528	19,988	104,693	194,847
<b>Total Liabilities</b>	<b>\$116,427,968</b>	<b>\$23,597,198</b>	<b>\$91,975,965</b>	<b>\$854,805</b>
Commitments and Contingencies (Note 15)				
<b>Net Position:</b>				
Unexpended Appropriations (Note 10)	\$9,813,595	\$1,537,026	\$160,481	\$8,116,088
Cumulative Results of Operations (Note 10)	(4,573,804)	(375,282)	(4,200,731)	2,209
<b>Total Net Position</b>	<b>\$5,239,791</b>	<b>\$1,161,744</b>	<b>\$(4,040,250)</b>	<b>\$8,118,297</b>
<b>Total Liabilities and Net Position</b>	<b>\$121,667,759</b>	<b>\$24,758,942</b>	<b>\$87,935,715</b>	<b>\$8,973,102</b>



**United States Department of Education**  
**Federal Student Aid**  
**Consolidating Statement of Net Cost**  
**For the Period Ended September 30, 2003**  
(Dollars in Thousands)

	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
<b>Program Costs</b>				
<b>Program A (Enhancement of Post Secondary and Adult Education)</b>				
Intragovernmental Gross Costs	\$6,568,899	\$482,118 /	\$6,062,657	\$24,124
Less: Intragovernmental Earned Revenue	1,533,817	457,669	1,076,148	
<i>Intragovernmental Net Costs</i>	5,035,082	24,449	4,986,509	24,124
Gross Costs with the Public	21,950,314	2,818,211	5,051,810	14,080,293
Less: Earned Revenues from the Public	4,954,244	19	4,954,206	19
<i>Net Costs with the Public</i>	16,996,070	2,818,192	97,604	14,080,274
<b>Program A Total Net Cost</b>	<b>\$22,031,152</b>	<b>\$2,842,641</b>	<b>\$5,084,113</b>	<b>\$14,104,398</b>
<b>Net Cost of Operations</b>	<b>\$22,031,152</b>	<b>\$2,842,641</b>	<b>\$5,084,113</b>	<b>\$14,104,398</b>

**United States Department of Education**  
**Federal Student Aid**  
**Consolidating Statement of Changes in Net Position**  
**For the Period Ended September 30, 2003**

(Dollars in Thousands)

	Consolidated			Federal Family Education Loan Program			Direct Student Loan Program			Grant Programs		
	Cumulative Results	Unexpended Appropriations	Cumulative Results	Unexpended Appropriations	Cumulative Results	Unexpended Appropriations	Cumulative Results	Unexpended Appropriations	Cumulative Results	Unexpended Appropriations	Cumulative Results	Unexpended Appropriations
Beginning Balance	\$ (3,910,830)	\$ 10,225,861	\$ (201,964)	\$ 1,388,597	\$ (3,711,170)	\$ 175,769	\$ 2,304	\$ 8,661,495				
Beginning Balance, As Adjusted	\$ (3,910,830)	\$ 10,225,861	\$ (201,964)	\$ 1,388,597	\$ (3,711,170)	\$ 175,769	\$ 2,304	\$ 8,661,495				
Budgetary Financing Sources												
Appropriations Received		\$ 25,353,248		\$ 6,516,826		\$ 5,385,922		\$ 13,450,500				
Appropriations Transferred - In/Out (+/-)		(14,699)		(13,749)				(950)				
Other Adjustments (+/-)		(572,369)		(413,697)				(158,672)				
Appropriations Used	\$ 25,178,446	(25,178,446)	\$ 5,940,951	(5,940,951)	\$ 5,401,210	(5,401,210)	\$ 13,836,285	(13,836,285)				
Other Financing Sources												
Imputed Financing (Note 12)	30,373		202,618		(440,263)		268,018					
Adjustments to Financing Sources (+/-)	(3,840,641)		(3,474,246)		(366,395)							
Total Financing Sources	\$ 21,368,178	\$ (412,266)	\$ 2,669,323	\$ 148,429	\$ 4,594,552	\$ (15,288)	\$ 14,104,303	\$ (545,407)				
Net Cost of Operations (+/-)	\$ (22,031,152)		\$ (2,842,641)		\$ (5,084,113)		\$ (14,104,398)					
Ending Balances (Note 10)	\$ (4,573,804)	\$ 9,813,595	\$ (375,282)	\$ 1,537,026	\$ (4,200,731)	\$ 160,481	\$ 2,209	\$ 8,116,088				

United States Department of Education  
Federal Student Aid  
Combining Statement of Budgetary Resources  
For the Period Ended September 30, 2003  
(Dollars in Thousands)

	Combined		Federal Family Education Loan Program		Direct Student Loan Program		Grant Programs	
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts
<b>Budgetary Resources:</b>								
Budget Authority :								
Appropriations Received	\$25,353,248		\$6,516,826		\$5,385,922		\$13,450,500	
Borrowing Authority		\$21,726,323				\$21,726,323		
Net Transfers	(14,699)		(13,749)				(950)	
Unobligated Balance:								
Beginning of Period	3,524,621	7,804,299	2,203,316	\$7,305,301	14,001	498,998	1,307,304	
Spending Authority From Offsetting Collections:								
Earned								
Collected	5,303,723	32,954,804	4,937,253	10,400,299	366,470	22,554,505		
Change in Unfilled Customer Orders								
Without advance from Federal sources	513				513			
Subtotal	\$5,304,236	\$32,954,804	\$4,937,253	\$10,400,299	\$366,983	\$22,554,505		
Recoveries of Prior Year Obligations	864,370	268,890	419,020	4,946	6,715	263,944	438,635	
Permanently Not Available	(5,706,555)	(17,401,499)	(5,181,515)		(366,395)	(17,401,499)	(158,645)	
<b>Total Budgetary Resources (Note 13)</b>	<b>\$29,325,221</b>	<b>\$45,352,817</b>	<b>\$8,881,151</b>	<b>\$17,710,546</b>	<b>\$5,407,226</b>	<b>\$27,642,271</b>	<b>\$15,036,844</b>	
<b>Status of Budgetary Resources:</b>								
Obligations Incurred: (Note 13)								
Direct	\$27,005,648	\$35,587,722	\$6,884,579	\$8,448,524	\$5,380,938	\$27,139,198	\$14,740,131	
Reimbursable	513				513			
Subtotal	\$27,006,161	\$35,587,722	\$6,884,579	\$8,448,524	\$5,381,451	\$27,139,198	\$14,740,131	
Unobligated Balance:								
Apportioned	47,684	395,950	2,622	395,950	11,774		33,288	
Unobligated Balance Not Available	2,271,376	9,369,145	1,993,950	8,866,072	14,001	503,073	263,425	
<b>Total Status of Budgetary Resources</b>	<b>\$29,325,221</b>	<b>\$45,352,817</b>	<b>\$8,881,151</b>	<b>\$17,710,546</b>	<b>\$5,407,226</b>	<b>\$27,642,271</b>	<b>\$15,036,844</b>	
<b>Relationship of Obligations to Outlays:</b>								
Obligated Balance, Net, Beginning of Period	\$9,918,833	\$6,786,293	\$1,390,896	\$1,381,889	\$301,840	\$5,404,404	\$8,226,097	
Obligated Balance, Net, End of Period:								
Unfilled customer orders from Federal Sources	(\$513)				(\$513)			
Undelivered Orders	\$9,546,177	\$8,373,221	\$1,591,517	\$922,551	\$135,285	\$7,450,670	\$7,819,375	
Accounts Payable	786,526	16,338	6,071	8,238	120,497	8,100	659,958	
Outlays:								
Disbursements	25,727,920	33,715,565	6,258,866	8,894,678	5,420,794	24,820,887	14,048,260	
Collections	(5,303,723)	(32,954,804)	(4,937,253)	(10,400,299)	(366,470)	(22,554,505)		
Subtotal	\$20,424,197	\$760,761	\$1,321,613	(\$1,505,621)	\$5,054,324	\$2,266,382	\$14,048,260	
Less: Offsetting Receipts	43,572						43,572	
<b>Net Outlays (Note 13)</b>	<b>\$20,380,625</b>	<b>\$760,761</b>	<b>\$1,321,613</b>	<b>(\$1,505,621)</b>	<b>\$5,054,324</b>	<b>\$2,266,382</b>	<b>\$14,004,888</b>	<b>(\$0)</b>



**United States Department of Education  
Federal Student Aid  
Consolidating Statement of Financing  
For the Period Ended September 30, 2003**

(Dollars in Thousands)

	Federal Student Aid	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Resources Used to Finance Activities				
Budgetary Resources Obligated				
Obligations Incurred (Note 13)				
Less: Spending Authority from Offsetting Collections & Recoveries	\$(62,593,883)	\$(15,333,103)	\$(32,520,649)	\$(14,740,131)
Obligations Net of Offsetting Collections and Recoveries	39,392,300	15,761,518	23,192,147	438,635
Less: Offsetting Receipts	(23,201,583)	428,415	(9,328,502)	(14,301,496)
Net Obligations	(43,572)			(43,572)
Other Resources	\$(23,245,155)	\$428,415	\$(9,328,502)	\$(14,345,068)
Imputed Financing From Costs Absorbed by Others (Note 12)	(30,373)	(202,618)	440,263	(268,018)
Net Other Resources Used to Finance Activities	(30,373)	(202,618)	440,263	(268,018)
Total Resources Used to Finance Activities	\$(23,275,528)	\$225,797	\$(8,888,239)	\$(14,613,086)
Resources Used to Finance Items Not Part of Net Cost of Operations				
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not Yet Provided (+/-)	\$(1,975,219)	\$237,533	\$(1,747,568)	\$465,184
Resources that Fund Expenses Recognized in Prior Period	(1,216,284)	2,504,006	(3,720,290)	
Credit Program Collections Which Increase/Decrease Liabilities for Loan Guarantees, or Credit Program Receivables, Net including Allowances for Subsidy	31,744,588	12,184,166	19,560,422	
Resources Used to Finance the Acquisition of Fixed Assets, or Increase/Decrease Liabilities for Loan Guarantees or Credit Program Receivables, Net in Current or Prior Period	(28,047,641)	(8,970,572)	(19,077,069)	
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	\$505,444	\$5,955,133	\$(4,984,505)	\$(465,184)
Total Resources Used to Finance the Net Cost of Operations	\$(23,780,972)	\$(5,729,336)	\$(3,903,734)	\$(14,147,902)
Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period				
Components Requiring or Generating Resources in Future Periods				
Increase in Annual Leave Liability	\$(3,322)	\$(3,322)		
Upward/Downward Reestimates of Credit Subsidy Expense	(1,317,771)	2,893,047	(4,210,818)	
Increase in Exchange Revenue Receivable from the Public	1,087,940		1,087,940	
Other (+/-)	40,642	(2,967)	10	43,599
Total Components of the Net Cost of Operations that Will Require or Generate Resources in Future Periods	\$(192,511)	\$2,886,758	\$(3,122,868)	\$43,599
Components Not Requiring or Generating Resources				
Depreciation and Amortization	\$1,942,426	\$(63)	\$1,942,489	
Other (+/-)	(95)			(95)
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources	\$1,942,331	\$(63)	\$1,942,489	\$(95)
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	\$1,749,820	\$2,886,695	\$(1,180,379)	\$43,504
Net Cost of Operations	\$(22,031,152)	\$(2,842,641)	\$(5,084,113)	\$(14,104,398)